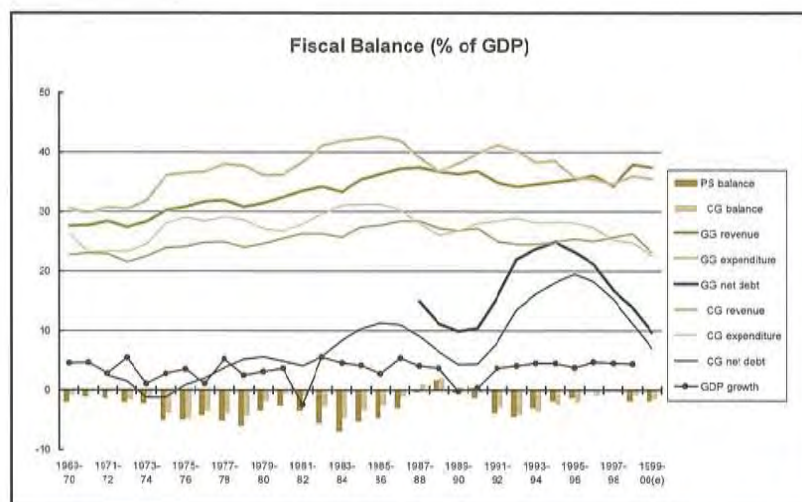


PACIFIC ECONOMIC OUTLOOK



Structure Project

Fiscal Policy Issues in the Pacific Region



In recent decades, the Australian government has actively used fiscal policy to stabilize the business cycle. Fiscal policy was expansionary in the early 1980s and again in the early 1990s to counter recession. In addition, international factors have influenced the stance of fiscal policy. For instance, in the late 1980s, fiscal policy was tightened to reduce Australia's persistent current account deficit. Since the mid-1990s, raising national savings through higher public savings and reducing the net public debt-to-GDP ratio have motivated the federal budget strategy. Australia is now in a relatively strong fiscal position by international standards with the entire government sector's net debt falling from a peak of around 25 percent of GDP in 1995 to an expected 7.5 percent of GDP in 2001.

The size of the government sector in Australia as a percentage of GDP remains at the lower end of the scale for OECD countries, and is of a similar order to that of the United States and Japan. The general government sector (comprising the federal, state and local governments) accounts for over one-third of total national spending and raises revenue equivalent to around a third of national income. The federal government collects the bulk of total revenue, though it accounts for a smaller proportion of total government outlay. This implies a degree of so-called vertical fiscal imbalance in Australia that is high by the standards of other federations, including the United States, Canada and Mexico.

The federal budget balance has mostly been in

deficit since the early 1970s with the exception of surpluses recorded in the late 1980s and from the late 1990s onwards. The direct tax base (i.e., income tax and company tax) accounts for most of the revenue. The main indirect tax in Australia is the goods and services tax that replaced a host of existing sales and other indirect taxes in 2000 and provides revenue for the states. The single largest component of federal outlay is government transfers in the form of social security and other welfare payments. Other significant items are expenditure on healthcare, education and training, defense and public debt interest.

To assist in the financing of budget deficits, the federal Treasury has in the past raised funds by issuing public debt instruments to domestic households, firms, financial intermediaries and the rest of the world. Government bonds are not as a rule issued to the central bank on the grounds that money financing of budget deficits is inflationary. The federal government estimates that its net debt will decline to around 7 percent as a proportion of GDP in FY00–01, with state/local government debt expected to be close to zero within a few years.

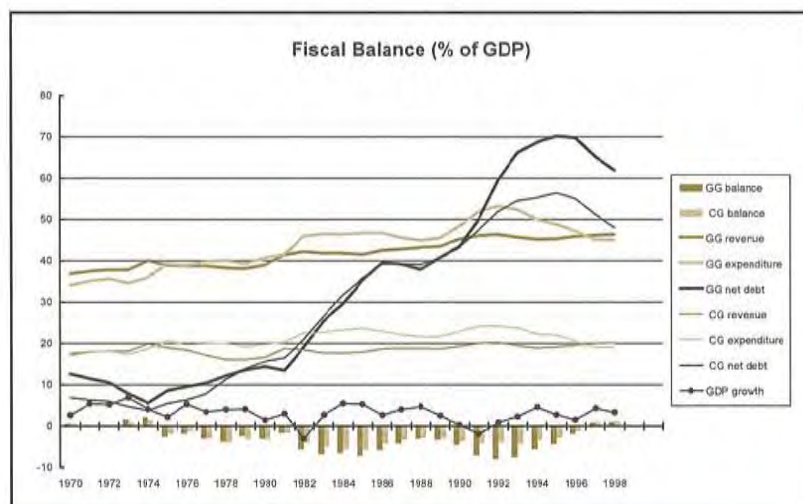
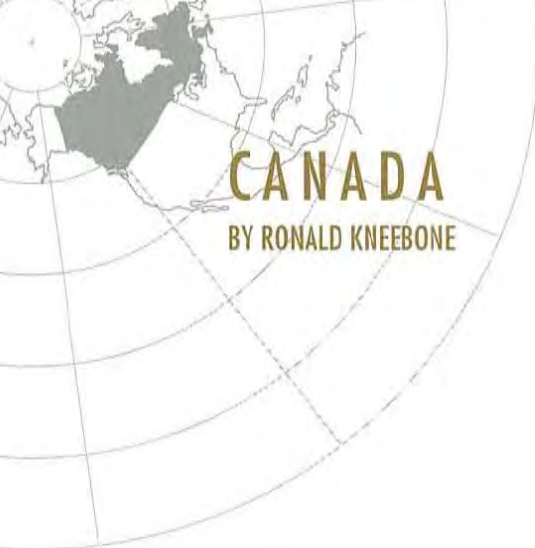
As a share of total outlay, public debt interest rose sharply in Australia in the mid-1990s after a series of sizeable federal budget deficits. More recently, budget surpluses have been used to retire the public debt and lower public debt interest payments. The continuous reduction in total net debt of the consolidated public sector partly reflects the use of

the proceeds of privatized assets to retire debt at the federal and state/local levels. The privatization of public assets in the areas of transport, financial services and utilities has provided a major alternative source of revenue, and public asset sales have been a frequent feature of federal and state budgets over the past decade.

The federal government operates under a Charter of Budget Honesty, an institutional framework that governs the formulation and reporting of the federal budgetary position. The Charter ensures greater discipline, transparency and accountability for fiscal policy, specifically requiring that governments maintain public debt at prudent levels, bearing in mind the intergenerational impact of higher public indebtedness. Governments are also obliged to provide comprehensive fiscal information before general elections and detail the means by which they will reverse temporary fiscal measures implemented to counter economic downturns. The legislation also requires that the fiscal authorities prepare regular annual reports on the budgetary strategy, the economic outlook and budget outcomes.

The most significant fiscal initiative affecting revenue-raising in Australia in recent years has been the introduction of a goods and services tax (GST) which took effect in FY00–01. The GST – which is applied to the sale of most goods and services, with the notable exception of basic food items – replaced a wholesale tax that had been levied on a shrinking manufactured goods base. Revenue from the GST is transferred to the state and territory governments for funding of essential services such as schools, hospitals and roads, and has allowed these governments to abolish numerous business and financial sector-specific taxes. Other benefits of this major reform of the taxation system include the removal of an indirect tax burden on business input costs and also on exporters.

There is evidence that past episodes of fiscal consolidation, such as those that occurred in the late 1980s and in FY96–97, have actually improved Australia's macroeconomic performance. In both instances, stronger-than-expected growth followed fiscal consolidation which was achieved by posting budget surpluses on the back of reduced government spending.



Canada has a federal government structure with government activities taking place at several levels: national (or federal), provincial, and local. The federal government is responsible for matters of national interest including national defense and foreign policy, international trade, competition policy, criminal law, and money and banking. The federal government is also responsible for the delivery of some of Canada's social programs (unemployment insurance, for example) but often shares this responsibility with the provinces. For all intents and purposes, the federal government has unlimited taxing powers as it is able to employ any system or mode of taxation it deems necessary. The provinces are responsible for programs in the areas of healthcare, education, and welfare. Provinces have extensive taxing powers, although they are somewhat more limited than the federal government in the sense that they do not have access to money finance. Compared with most other federations, Canadian provinces have a great deal of power and fiscal autonomy. Indeed the provinces, together with the local governments they control, account for about half of the activities undertaken by the public sector in Canada; thus in the aggregate, they are as important as the federal government when considering issues of fiscal policy.

One important aspect of the Canadian government is the role of transfers from the federal government to the provinces. Although the federal government is not directly responsible for programs related to

health, education and welfare, it has been able to exercise substantial influence over the provinces in these areas through "the power of the purse." The most important transfer program is the Canada Health and Social Transfer (CHST). Although the CHST is ostensibly to be used to finance provincial programs related to health, welfare and post-secondary education, it is in fact a block grant that goes to general provincial revenues and may be used as the provincial governments see fit. In addition to the CHST, the federal government provides equalization grants; these are unconditional transfers sent to the seven "have-not" provinces to enable them to provide government services of a quality roughly comparable to those provided by the three "have" provinces.

A feature of the Canadian economy that is problematic for policymakers is the fact that the Canadian economy is composed of a number of regional economies whose business cycles differ not only in amplitude, but also in period. Thus at any one time, monetary policy tends to be more appropriate for some regions than for others. Fiscal policy, to the extent that it can be regionally differentiated, can therefore play an important stabilization role.

The Canadian economy is small and open, particularly to the United States. Roughly 80 percent of Canadian exports and imports are to and from the United States. Since the signing of free trade agreements in 1988 and 1993, Canada's economic ties with the U.S. have grown even stronger. Interest

rates, inflation rates and real GDP growth rates in the two economies tend to move closely together.

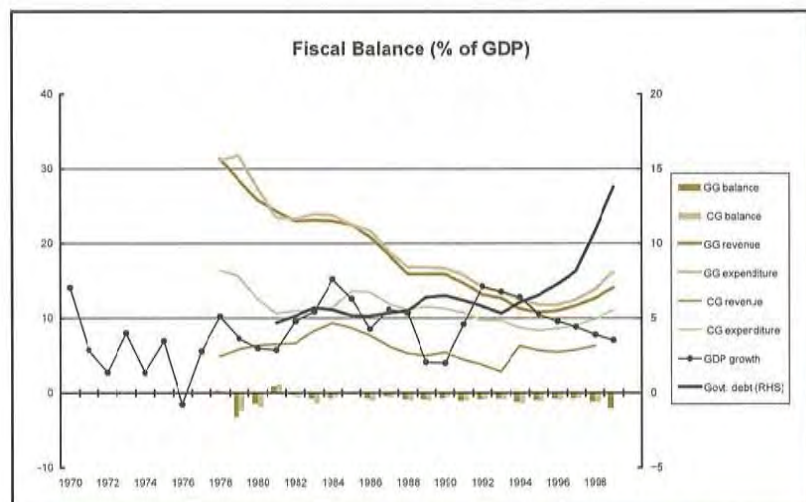
The dominant characteristics of Canadian fiscal policy since 1975 have been deficits and debt accumulation, growth in government spending, and a steady increase in the share of GDP going to taxes. Total government net debt, measured as a percentage of GDP, increased from 6 percent in 1974 to 70 percent in 1995. Removing the net asset positions of public pension plans, nonpension debt peaked at 80 percent of GDP in 1995. Most of this accumulation of debt occurred at the federal level of government with significant subnational debt accumulation occurring only in the early 1990s. An analysis of the reasons behind this debt accumulation indicates that at the federal level, fiscal policy choices were responsible for roughly one-third of the debt. The remainder of the debt is attributable to the impact of automatic stabilizers during the recession, and changes in the gap between the rate of economic growth and the interest rate paid on federal debt. Virtually none of the accumulated debt at the subnational level of government can be attributed to fiscal policy choices: that is, the economic cycle was the cause of the debt accumulation and only a favorable gap between the rate of economic growth and the interest rate paid on subnational debt saved these governments from an explosion in their debt-to-GDP ratios.

Since 1995, the debt-to-GDP ratio has been falling at all levels of government. For the most part, these reductions have been the result of fiscal policy choices as opposed to the benefits of economic expansion. Federal and subnational government taxes have steadily increased as a fraction of GDP since 1970. In what proved to be a successful effort to contain the growth in debt, all levels of government reduced program spending beginning in the mid-1990s. By 1998, all levels of government were running overall budget surpluses.

Coincidental with the accumulation of government debt and the increase in tax burdens, Canadian living standards have been falling relative to those in the U.S. since the early 1980s. Two deep recessions — one in the early 1980s and the other in the early 1990s — and fiscal policy choices made at the federal level of government caused debt to accu-

mulate relative to GDP. These events, which forced tax rates higher and spending on social programs lower in order to halt the accumulation of debt, are identified as culprits in explaining the fall in relative living standards.

At the end of the 20th century, Canada is poised to reap the benefits of three key macroeconomic policy choices made at the beginning of the 1990s. These three policy choices — the decision to target zero inflation, the decision to reduce government debt, and the decision to embrace free trade — all involve what economists refer to as “short-term pain for long-term gain.” The paper concludes that the short-term pain has largely been paid and Canada is now in a position to reap the long-term gain. Whether this scenario plays out depends on the ability of fiscal policymakers to use the surpluses currently enjoyed to reduce government debt and cut tax rates.



For China, the term fiscal revenue — where fiscal revenue consists of tax revenue, state-owned enterprises (SOE) subsidies, and other revenue — must be distinguished from government revenue and budget revenue. For the convenience of capturing fiscal issues in China, in this paper, we use government revenue although its scope is narrower than the conventional understanding of this term.

Since the economic reforms began in 1978, the share of government revenue and expenditure to GDP has declined steadily; this trend is also evident in the share of central revenue and spending to general government revenue and spending. This decline in the two ratios is one of the major consequences of institutional changes arising from several reforms that led to a change in the distribution of fiscal resources between the central and local governments. It should be noted that this occurred even though the central government tried to reverse the downward trend in the central government's share in an attempt to consolidate macroeconomic adjustment abilities.

The composition of government revenue has changed significantly in the past two decades, in parallel with the continuing transformation of the country's economic structure. Revenue from the commerce sector and from nonstate-owned enterprises has increased sharply; in contrast, revenue from the industry sector and from state-owned enterprises has declined. With regard to tax revenue, the government's reliance on consumption-

related taxes is increasing.

The 20 years of economic development, which can be viewed as a process of decentralization, resulted in a large amount of extra-budget revenue funds. Measured in absolute terms or as a percentage to government revenue, extra-budget revenue rocketed from 1978. The main reason for this trend has been the various reforms to reduce state intervention in enterprises and to increase the proportion of income retained at the enterprise level and even at the local government level. There is, however, no simple relationship between government revenue and the size of extra-budget funds. The former is constrained by the general state of economic activities, whereas the latter is influenced by policy and adjustments in budget regulations.

When the government began to expand its activities quantitatively and qualitatively — for example, in the development of infrastructure and in support of industrialization — the tax income could not keep up with expenditure needs, and an inevitable consequence was a growing public deficit and higher debt. A unique characteristic of national debt in China is that the government does not need to take into account the need for a majority vote to implement fiscal policy, but only justifies to itself the necessity of borrowing. Another political aspect of debt in China is the fact that a rising burden of interest payments narrows the room for maneuver in budgeting. In fact, it is indeed the case that interest payments on the national debt have

become one of the largest items of the central government budget.

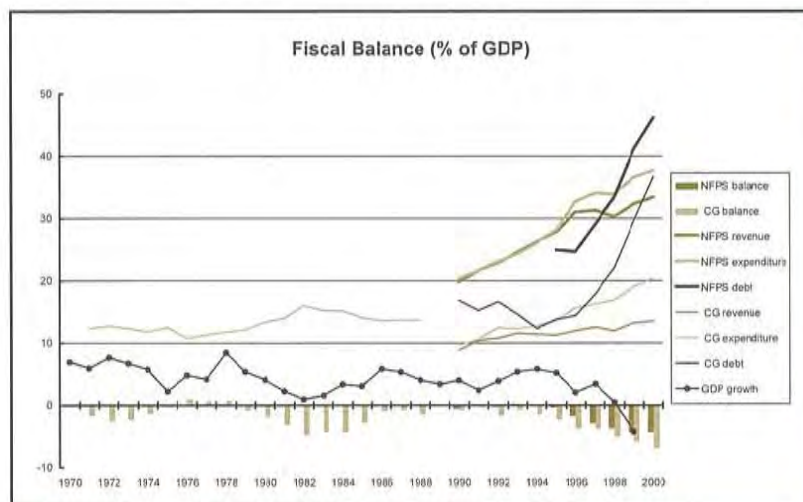
Fiscal policy before 1978 in China served as a substitute for a capital market, with the main source of investment funds from the early 1950s coming from the budget system. In its purest form, central planning implied that the revenue from taxes at all levels and the income of all SOEs should be handed over to the central government; the central government would then disburse the funds through its budget which included allocations for capital investment.

This fiscal system was replaced after 1978. Under the new system, each level of government agreed with the next higher level to meet certain income and expenditure targets as identified in a fiscal contract. This contract also stipulates any expenditure subsidy to be provided to the lower level, regardless of changes in its revenue during the contract period. The surplus income retained at the lower level could be used to cover new investment or other expenditure at its own discretion. There were five different sets of agreements of contracting system during the period 1978–1994.

The outcome of the 1994 fiscal reform is tax federalism, i.e., institutionalization of the decentralization of fiscal resources distribution. The reform was also a response to the massive decline in the two ratios mentioned above, which limited the government's ability to exercise macro adjustment. Rather than a negotiated percentage of locally collected revenue being remitted to the central government, taxes are now divided into three distinct categories: central taxes, local taxes, and shared taxes. The rule-based method is expected to reduce bargaining costs. However, this new system is a result of central concessions to local vested interests. Furthermore, the central government continues to determine the tax basis and rates of all taxes.

The new system continues to have many institutional defects that are vestiges of the old system. For example, the revenue-sharing contracts that were negotiated have been allowed to remain effective, there is still the remittance-refund between central and local governments, transfer arrangements continue to be extremely complicat-

ed, and in the end, the real question of central-local revenues at the constitutional level is still not clear.



In the early 1990s, the Colombian economy was subject to radical reforms that were concomitant with both specific domestic needs and emerging international trends. Some of these reforms were intended to modernize the general structure of the state, by reducing its size so as to make it more efficient. Other policies were aimed at boosting key economic sectors and render them more competitive in foreign markets.

Despite the reforms, ten years later, the Colombian state is 80 percent larger than before and its financial sustainability poses serious problems. In 1999, GDP growth of Colombia was -4.3 percent and the unemployment rate had reached 20 percent. This dwindling in economic activity has been coupled with imbalances in the macroeconomic accounts, particularly in the public sector.

The paper provides a general overview of Colombia's economic evolution during the last few decades of the 20th century, and examines more closely some of the factors that have undermined the country's public finances during this period. The paper begins with an overview of the fiscal imbalances registered as of the 1960s, and their relationship with both the real business cycle and tax policy. The paper then summarizes the main economic reforms (in the trade, financial, labor, social security, and exchange fields) introduced in the early 1990s, and compares the size of the Colombian public sector with those of several neighboring countries. By the end of the 1990s,

Colombia's public sector was much larger than the average for the Latin American region (in terms of GDP, Colombia's public sector share is 8 points above the regional average).

The paper identifies a group of key issues involved in the country's recent fiscal imbalance. Some of these issues are related to the finances of the central government, and others are related to the consolidated results of the public sector at large. Overall, these issues indicate that the fiscal imbalance of the nonfinancial public sector in Colombia has sharply increased, particularly after 1995 (from 0.3 percent of GDP in 1995 to 4.3 percent in 2000). As a result of this fiscal trend, the public sector at large has widely increased the size of its domestic and foreign debt.

Subsequently, the paper analyzes the dynamics of the public debt and questions its sustainability. Between 1995 and 2000, the consolidated public debt of the nonfinancial public sector as a share of GDP climbed from 24.9 percent to 46.2 percent, not counting social security liabilities. All of this increase was explained by the central government's indebtedness. Simultaneously, the interest payments made by the central government on its domestic and foreign debt have increased since 1995 (from 1.2 percent of GDP in 1995 to 4.5 percent by 2000).

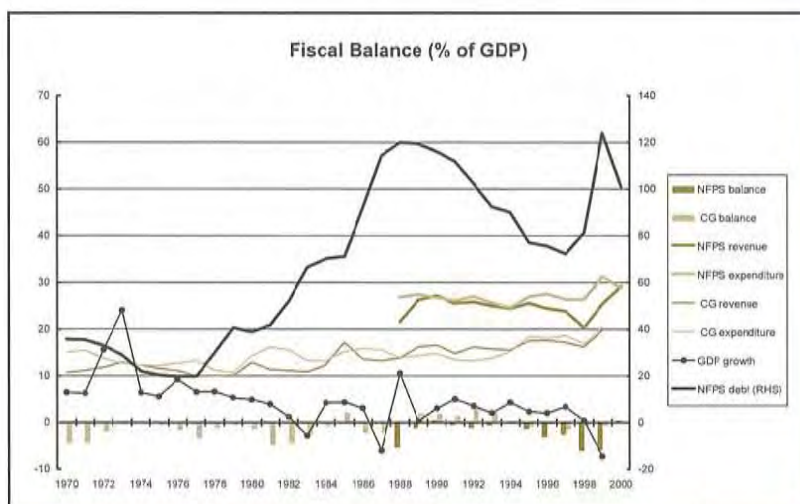
To evaluate the sustainability of the public debt, the paper uses both the standard debt sustainability

approach and a variety of internal and external indicators that are used by international financial institutions. These indicators are also useful for assessing the vulnerability of small countries such as Colombia to external financial shocks. The data indicate an evident erosion of Colombia's main economic variables since the mid-1990s.

The paper concludes by outlining current policies for economic adjustment and growth. These policies, which are mostly related to public finance, are being implemented under the three-year agreement that the Colombian economic authorities and the IMF signed in December 1999.

ECUADOR

BY GUSTAVO ARTETA



This paper analyzes fiscal performance in Ecuador for the period 1970–2000 and considers the path for future policies. The historical trends show that the Ecuadorian government mismanaged public accounts for many years and overrelied on oil revenue that was susceptible to boom and bust cycles. History notwithstanding, recent reforms in the institutional structure and tax regimes are showing positive results so that the expectation of a brighter future is on the horizon.

The Ecuadorian public sector structure is based on a centralized budgetary system that governs most of the public sector finances, except for autonomous (off-budget) agencies, enterprises and local governments. The central government represents about 80 percent of the consolidated nonfinancial public sector (NFPS); the “rest of the general government” represents about 12 percent, while public enterprises represent about 8 percent of the total. Relative to the country’s GDP, NFPS expenditures have averaged about 26.8 percent in the last ten years.

Highly dependent on revenue from oil exports and a rigid structure with almost 40 percent destined to debt service, Ecuador’s fiscal accounts have been volatile and fragile. The government posted deficits in 21 of the last 30 years. Despite various reform efforts that managed to decrease the share of oil revenue in total central government revenue from 71 percent in the 1970s to about 35 percent by 1999, the heart of the country’s fiscal problems

have not yet been fully addressed. As a result, natural phenomena and the price of oil have determined economic performance and fiscal finances.

The transformation of the economy by the large-scale exploitation of oil in the early 1970s produced a “Dutch Disease” in the government accounts. Tax collection gave way to OPEC-fueled revenue. The country lost the sense of “tax-paying” at the national and local levels that, in turn, created a fatal dependence on oil revenue. Once the boom ended by 1980, fiscal deficits were growing at an alarming pace and foreign public debt ballooned from US\$213 million in 1970 to US\$3,500 million in 1980. In addition, after assuming about US\$3,000 million of private sector debt that was at the brink of bankruptcy and posting continuous deficits, a few years later, overall public debt had escalated to over 100 percent of GDP, which required tough measures.

Various adjustment programs were implemented; however, these created a vicious cycle of austerity packages, devaluations and public protests that were followed by a slackening of fiscal policy and accelerating inflation. As a result, Ecuador has only completed one of eight IMF accords, and has defaulted or fallen into debt arrears thrice.

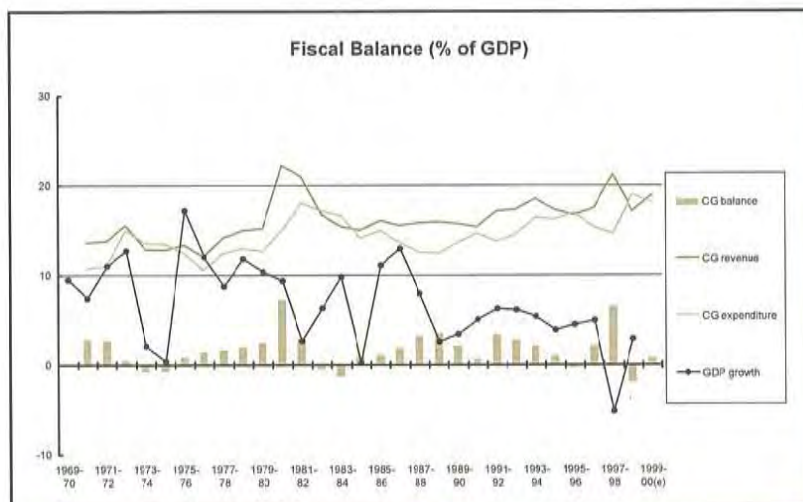
The fiscal disarray provided for a tendency to finance the deficits through money creation, but this led to chronic high inflation and an accumulated devaluation of currency by 88,900 percent in 20

years. Thus, it is no surprise that the country suffered repeated currency and debt crises. In 1999 and 2000, these were pushed to the limit by the collapse of the financial system that strained government finances, accelerated inflation and devalued the currency 340 percent in a single year. As a result and under conditions of political instability, the government opted to abandon its currency and control of its monetary policy by adopting the U.S. dollar as its official currency in March 2000.

Dollarization will pose various policy challenges. Without the option to monetize deficits and in light of a highly indebted public sector with low creditworthiness, the government faces strict financing constraints that could almost eliminate the possibility of running deficits (at least in the near future). This could help change Ecuador's track record and allow it to take meaningful steps toward fiscal sustainability. However, it will also challenge the country and society as a whole into adopting the necessary policies to attain fiscal balance and tackle the adjustment processes that may be induced by external shocks to its primary commodity-based economy.

Fiscal sustainability in the future will depend on the government's ability to provide more stable revenue sources and to create budgeting flexibility on the expenditure side. On the first issue, Ecuador has been making significant progress in tax reform and institutional building since 1998. An autonomous tax collection agency (the SRI) was created with a strong institutional framework, and with the power and instruments to collect taxes more effectively and penalize tax evaders. So far, the results have been outstanding. Ecuador has posted two consecutive years of real revenue growth of more than 30 percent, it has increased the number of registered taxpayers by 2,000 percent, and it is well on its way toward consolidating modern information-crossing systems. In 2000, value-added tax collections achieved the efficiency standard for developing countries as gauged by "revenues/GDP equal to half the nominal tax rate," and the trend for 2001 points to surpassing this standard. These efforts are being helped by recent increases in the value-added tax rate from 10 to 14 percent, and record levels of income tax collections.

To further consolidate its fiscal finances, the government now plans to tackle problems in customs, where evasion and corruption remain rampant. Also in two years, the government will begin to receive the benefits of the construction of a second oil pipeline that will double current transport capacity and should provide an additional 2–4 percent of GDP in fiscal revenue. These actions are on track to provide sufficient additional revenue to invert the previous average of 2.5 percent of fiscal deficit-to-GDP, to surpluses. Of course, this assumes that expenditure is not increased, which is likely to pose a challenge to Ecuador, a country that is characterized by a weak political system and institutions. Nevertheless, the recent reforms have built an unprecedented foundation that is providing Ecuador with a real window of opportunity to attain fiscal sustainability in the future.



Over the past years, fiscal policy in Hong Kong, China (hereafter referred to Hong Kong) has been guided by the principle of prudence, with emphasis on self-support and a balanced budget. This has contributed to consistently healthy public finances, which are among the positive fundamentals in Hong Kong that underpin its business environment and its long-term growth and development.

Under the “one-country, two-systems” principle, the Basic Law stipulates that the Hong Kong Special Administrative Region (HKSAR) shall, inter alia, retain autonomy in its fiscal affairs. Specifically, the HKSAR government shall continue to maintain fiscal balance, restrain the size of the public sector in relation to the economy, and implement a low tax policy. A well-established legislative framework and an independent audit system are in place to ensure effective management, supervision and control of the fiscal system in conformity to these policy guidelines.

Thus Hong Kong fiscal policy primarily seeks to avoid successive or structural budget deficits, and where possible, to budget for surplus in order to build up substantial fiscal reserves for supporting government expenditure in the event of adversities and for meeting emergencies. The policy also seeks to support the free-market and free-enterprise system. In addition, the policy is oriented toward promoting social development in tandem with economic growth, by assisting people in need and by ensuring equal opportunities to all for individual

betterment.

Hong Kong’s budgetary position has been consistently strong since the 1970s, as manifested by positive balances in the government account during most of the past three decades. Expressed as a ratio of nominal GDP, the size of the budget surplus averaged 2.7 percent in the 1970s, 1.7 percent in the 1980s, and 1.5 percent in the 1990s. This robust outcome is partly attributable to rapid growth in government revenue, which benefited from the significant overall economic growth over the years and the buoyant property market up to 1997. Another contributing factor was the restraint by the government on its spending.

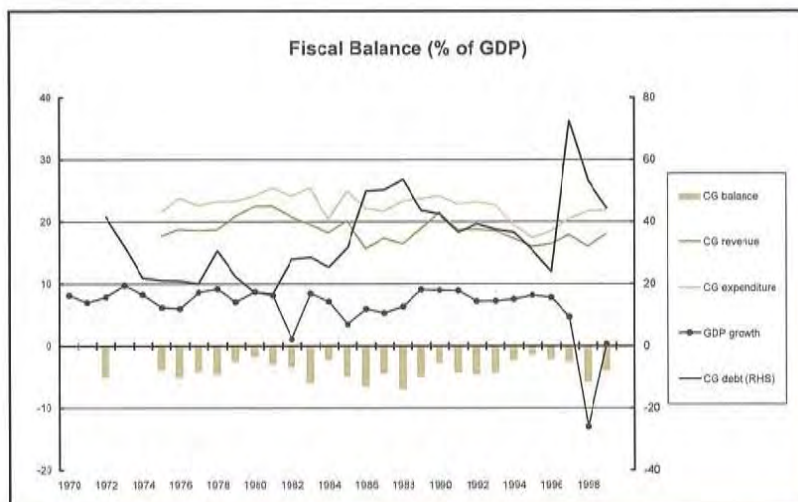
By the end of March 2001, the government had accumulated HK\$430 billion in fiscal reserves, equivalent to 185 percent of the government expenditure in FY00–01 or 34 percent of nominal GDP in 2000. This obviated the need for the government to borrow and resulted in a debt-free government balance sheet.

While fiscal policy in Hong Kong is not used as a tool to influence private sector business activities or augment their perspectives at the micro level, it has a distinct role to play at the macro level in terms of promoting growth and facilitating stability of the economy. First, neutrality of the fiscal structure is commensurate with a competitive market environment. Second, it is expected that fiscal means will be used to help stabilize the economy

when it undergoes severe swings, by loosening or tightening the fiscal stance as appropriate. Third, the simple, low and predictable tax regime contributes to a favorable business environment for enterprise growth, investment interest and work incentive. Fourth, the market-friendly fiscal policy, together with the supportive public infrastructure, facilities and services, foster economic transformation and upgrading to higher value-added activities. Fifth, the redistributive function through the fiscal mechanism helps to preserve social stability, and the public resources invested in education, training and retraining serve to promote self-reliance and social mobility.

The government is, however, alert to the risk of a structural deficit that could stem from a more protracted operating deficit and a lower level of land sales and property-related revenue than has previously existed. If the operating deficit turns out to be truly structural in nature, a possible solution lies in strengthening the revenue base by introducing new taxes and reducing the subsidy to a variety of government fees and charges. In parallel, the government is obliged to exercise even tighter restraint on its expenditure, along with even greater effort to enhance efficiency in its regular operations.

Hong Kong should stick to its well-founded fiscal tradition. For the sake of prudence, any expenditure and revenue proposals — particularly those involving longer-term commitments — will have to be examined carefully, since once granted they may be politically difficult to withdraw or alter. Also, the fiscal structure will have to keep up with the evolving economic, social and community needs. It is important for the resource allocation exercise in each round of the government budget to be consistently and systematically executed in light of such considerations.



Throughout the era of the New Order Government and up to the present, the Indonesian government has continued to run a balanced budget policy. However, the balanced budget policy is a deceiving term since it does not meet the standard accounting criteria of a balanced budget; rather, the balanced budget is defined in such a way that total government receipts from all sources, including foreign borrowing, will equal total expenditure. In other words, items that are elsewhere classified as a means of financing the budget deficit have been classified as receipts in Indonesia. The purpose of the balanced budget policy is to impose fiscal discipline and to avoid the 1960s experience of budget-induced hyperinflation.

Faced with the grim prospect of the future oil market, the Indonesian government has succeeded in shifting its development strategy. Moving away from a heavy reliance on oil revenue, it now emphasizes mobilization of tax revenue from non-oil sectors. For this purpose, the government launched general economic reforms in 1986 that were preceded by the 1984 tax reform. The objectives of the tax reforms were to increase non-oil tax revenue, to streamline the tax laws and improve the administrative system, to reduce tax-induced distortions in the allocation of resources, and to protect the poor from the adverse impact of the tax reform. In the short time span after the launching of the tax reform, the overall revenue objective has been largely achieved.

From the beginning, it was obvious that the prospect of using fiscal policy for demand management is very limited. Given this limitation, the Indonesian government focused on using the budget as a tool of allocation. However, as the burden of debt servicing continues to increase, the government's ability to use the budget as a tool of allocation is further eroded. Capital expenditure, which is crucial for boosting economic growth and reducing inequality across regions, must yield to make room for debt-servicing expenditure. Thus, a rapid increase in debt expenditure will result in a lower growth potential and, at the same time, greater inequality.

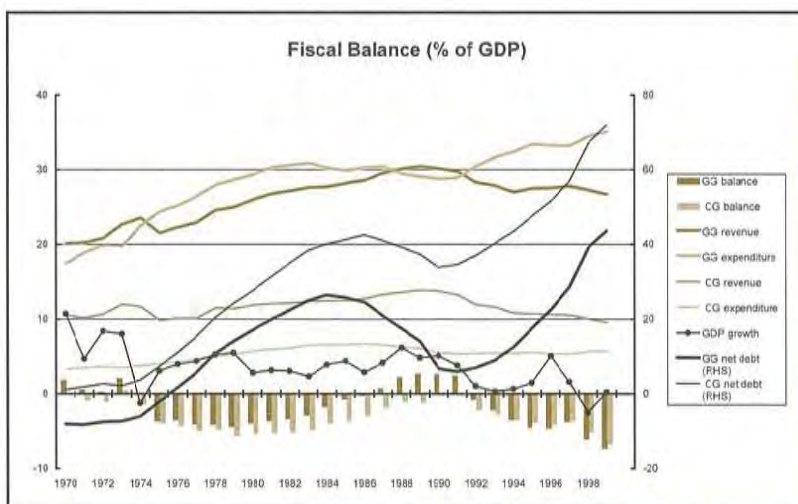
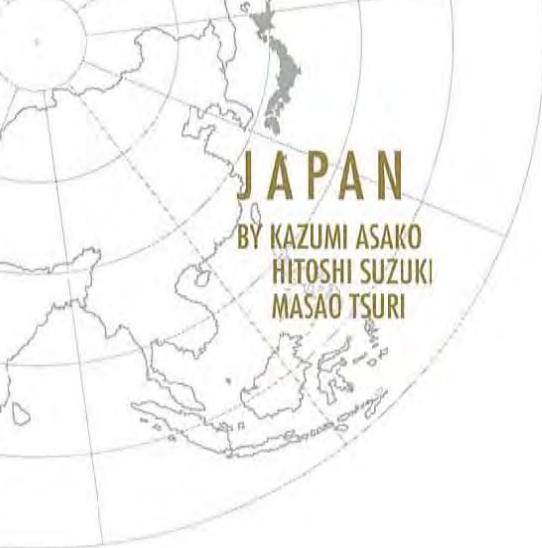
In the category of routine expenditure, personnel expenditure also must stay frozen for a period of time. This has further consequences on the efficiency of the government bureaucracy in general, as civil servants find it is almost impossible to live on their low salaries. Supplements to these low salaries are thus taken from development expenditure. But there is no clear standard on how civil servants are to be paid from development expenditure, and the allocations depend solely on the discretion of the superiors. What emerges then is a network of patronage, which is highly prone to corruption and abuse of power. Although civil servants have somewhat avoided the negative impact of the low base salary, in the process, the integrity and efficiency of the government bureaucracy have been greatly compromised.

With regard to fiscal management, the increase in government debt is inevitable at times of economic crisis. The need for fiscal stimulus to a crisis-stricken economy required a large budget deficit, which had to be financed in a non-inflationary way by inflows of official capital from abroad. The need to avoid total collapse of the banking system also required a large injection of public capital into the banking system, which was financed through government bonds. Although much of the new borrowing has been from concessional official sources, the cost of servicing the new debt will place pressure on the country's economic growth and its future balance of payments. This could mean a slower recovery and a lower level of sustained growth for the economy.

Responding to the question of fiscal sustainability, during the 1990–1998 period, the government successfully achieved a sustainable level of foreign public debt. The level of the actual operational deficit as a percentage of GDP during this period is lower or at the same level as it was in 1990. This means that the required deficit reduction was close to zero. The dominance of foreign borrowing as a means of financing the government budget deficit has made fiscal sustainability susceptible to fluctuations in the exchange rate. Therefore, maintaining exchange rate stability is very important in dealing with the issue of fiscal sustainability. At present, movements in the exchange rate are influenced by many non-economic factors — such as the political situation and social unrest — that seem to exert a dominant influence. Maintaining political stability and social order are therefore necessary conditions in order for the government to avoid an insolvency problem.

On the issue of regional finance, the demand for greater regional autonomy has prompted the government and the legislative body to design a new law of regional autonomy that regulates the transfer of fiscal authority and responsibility from the central government to the provincial and municipal levels. However, this means that potential revenue for the central government, without finding alternatives or cutting expenditure, cannot sustain the budget deficit for too long. The positive side is that if done correctly, decentralization not only empowers people to shape their own lives, but it can also enhance a nation's political cohesion and

economic competitiveness. On the other hand, if done poorly, it can lead to macro instability, more rather than less corruption, a worsening of the investment climate, overexploitation of natural resources and even disintegration of the nation.



The budget deficit of the general government of Japan, after excluding social security funds, or the aggregate budget deficit of central and local governments, was 8.2 percent of GDP in FY99 and it is expected to be 9.4 percent of GDP in FY00. Moreover, the outstanding financial liabilities (gross) of general government reached as high as 122.7 percent of GDP at the end of FY99. At the same time, however, financial assets have accumulated and, correspondingly, net financial liabilities were as low as 43.6 percent of nominal GDP at the end of FY99. As such, a distinguishing feature of Japan is the substantial differential in outstanding financial liabilities of the government when viewed on a gross and net basis.

The rise and fall in the government deficit had completed a 15-year cycle in 1990, which is the period of focus for our discussions on deficit-financing bonds (deficit bonds) of the general account for the central government. Deficit bonds were first issued in FY75 to finance an acute shortage in revenue, directly due to the recession after the first oil crisis. From FY76 to FY79, an increasing amount of deficit bonds was planned and intended.

In retrospect, the increase in deficits in the second half of the 1970s was due to a combination of several factors. First, the government misread the country's growth potential, which seemed to have experienced a "kink" in 1974–1975 and it took more than a few years before the government real-

ized this. On the expenditure side, social security programs and other items were not carefully monitored. It could have been that the hope of introducing a new tax made the government lax about expenditure increases.

The revenue gap was covered by deficit bonds, which increased their weight in the revenue share over the FY76 to FY80 period. From FY79 to FY82, efforts were made to reduce the size of deficit bonds at the planning stage. However, an economic slowdown in 1981–1982, partly due to the second oil crisis, necessitated another increase in deficit bonds. Since FY83, deficit bond issues have been gradually reduced in a politically acceptable manner—namely, a nominal freeze on expenditure and a nominal freeze on tax brackets. Major positive surprises in tax revenue in FY88 and FY89 eliminated all but a trivial amount of the deficit. These surprises in the tax revenue were mostly due to forecast errors in Japan's economic growth rate.

The Japanese government, however, again began issuing deficit bonds in 1994. It is not clear when this new rise in deficits will subsequently turn and fall, and thereby complete the second cycle. In contrast to the intended increase in deficits during the latter half of the 1970s, the second rise in deficits starting in FY94 are unintended. In particular, unintended shortages in tax revenue were significant throughout the 1990s. In the 1990s, the general government's direct taxes as a proportion

of GDP fell rapidly, and in FY98 and FY99, this ratio dropped below that of indirect taxes. Moreover, in FY92 and FY93, construction bonds rather than deficit bonds were issued in large magnitudes. The trend in government investment in the 1990s reflected a fiscal policy where successive stimulus packages were implemented to maintain growth in public works spending and to keep this spending at a high level.

It is true that the Japanese economy has been in a transitional phase throughout the 1990s from the "good old days" or "Japan-as-number-one" type quasi-open economy to a competitive market, fully open economy. However, the traditional Keynesian demand management has not worked sufficiently throughout the post-bubble period partly because the public's expectations about the future course of the economy have never become strong enough to vitalize the animal spirits and partly because the bad loan problem has prevented the economy from flexibly utilizing its resources. It is conceivable that the government has taken a rather optimistic stance in the sense that it was believed that once land and stock prices returned to higher levels, most of the problems in the Japanese economy would be cured and the good old days would return.

With these conditions and background in mind, the fiscal issues of Japan are now being debated. Specifically, the move toward greater decentralization in Japan is worthy of attention since it has the potential of appropriately reallocating administrative authority and revenue sources between the central and local governments, thereby increasing the efficiency of public finances overall. More recently, public works projects are required to undergo cost-benefit analyses, and explorations are under way toward increasing the efficiency and transparency of public works spending and reviewing the allocation of the budget for public works projects. Although the amount of public works spending is decreasing at this time, the spending remains high as a percentage of GDP when compared with other nations.

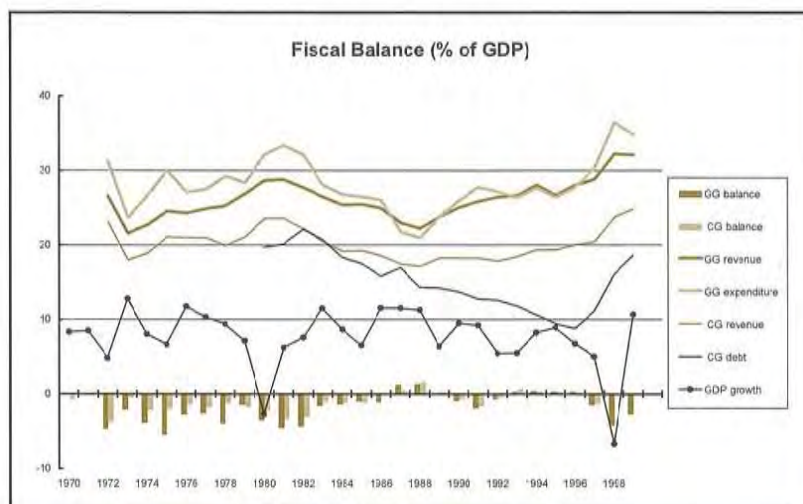
Moreover, the reform of the public pension and health insurance systems are also being debated. The argument is being made that it should be possible to increase the efficiency of both the funding

(i.e., how to divide revenue sources between contributions and taxes) and payments of these programs. From the viewpoint of taxation, Japan's taxpayer burden is low compared to other nations, and there is considerable room for increasing revenues. It should be possible to explore avenues for raising the efficiency of tax collection, including a suitable combination of direct and indirect taxes, through the restructuring of the overall tax system.

In practice, the reform of the Fiscal Investment and Loan Program (FILP) which has played a major role in Japan's fiscal policies started extensively in April 2001. Since market principles are supposed to come into play to some degree on the management of projects undertaken by FILP and public institutions, there is reason to hope that the amount of transfers from the government to public corporations will be reduced, which, in turn, would be a favorable development for the government's financials. Furthermore, what is certain is that the public sector's cost of funds (that is, the credit risk) will be exposed to a greater extent to market principles.

The long-term interest rate could therefore bear a risk premium to reflect the government's fiscal situation. The interest rate of Japanese government bonds has been crawling at a historically low level throughout the post-bubble period. At present, we can surmise, through a quick test of checking the sustainability condition concerning the Japanese budget through the working of the government bond market, that either the budget is being fundamentally met or it is not being paid serious attention.

If the present deficits are to be forever sustained, strong sustainability of the budget will result only if whatever necessary means are readily introduced. For instance, there is still enough room for the Japanese government to raise tax revenue if the political costs are willingly paid. There is also room to curtail expenditure in such areas as inefficient public works and backward-looking subsidies to incompetent industries. Reflecting in this way, even without any further concrete empirical analyses, it would be safe for us to summarize that the strong sustainability of deficits in Japan is not a serious economic problem, but is more of a political issue.



In order to sustain the pace of economic recovery, Korean monetary and fiscal policies need to play a fundamental role. In short, having launched an ambitious program to transform its economic system, Korea needs to follow through on the implementation of these reforms. Such reforms, together with appropriate macroeconomic policies, will boost the supply potential of the Korean economy and reduce its vulnerability to shocks, thereby sustaining rapid economic growth in the years to come.

Although Korea has experienced extreme political and social changes since the Korean War, her economy has grown rapidly. The foundations for this rapid economic growth lie in the promotion of industrialization and exports in the 1960s and 1970s, while price stabilization and adjustment of the industrial structure were implemented in the 1980s and 1990s.

While there are many important factors behind the rapid and outstanding economic development of Korea, it is clear that fiscal policy played an important role in forming the infrastructure for economic development and in supporting key and strategic industries. Yet, compared with advanced countries, fiscal policy in Korea has been criticized for playing a passive role in improving either the income distribution or economic classes. Nevertheless, generally speaking, Korean fiscal policy over the past 30 years has made a great contribution to price stabilization and effective distribution of financial resources to support economic devel-

opment, while keeping to prudent public finance principles.

In order to overcome the limitation of annual budgeting in improving efficiency and flexibility, Korea adopted pluri-annual budgeting in 1998. The government developed the Medium-Term Fiscal Plan, which lays out indicative targets for fiscal investment, sources of revenue, budget balance, etc.

A number of channels exist to incorporate a wide range of public opinion into the budget process, including special interest groups, experts from relevant fields, and local communities. These channels of communication include a system through which interest groups can assess the performance of their concerned ministry, public debates are held on budgetary policy for major spending areas, and budgetary conferences of mayors and province governors are convened.

Taxes in Korea comprise both national and local taxes (LT). Currently, national taxes can be divided into internal taxes (DT), custom duties (CT), the transportation tax (TT), the education tax (ET), and a special tax for rural development (AT).

The financial crisis has forced the government to initiate a series of comprehensive economic reform measures and to assist the unemployed in the form of a social safety net. Due to the sharp decline in consumption and investment in 1998, the government revised several tax laws to promote tax incen-

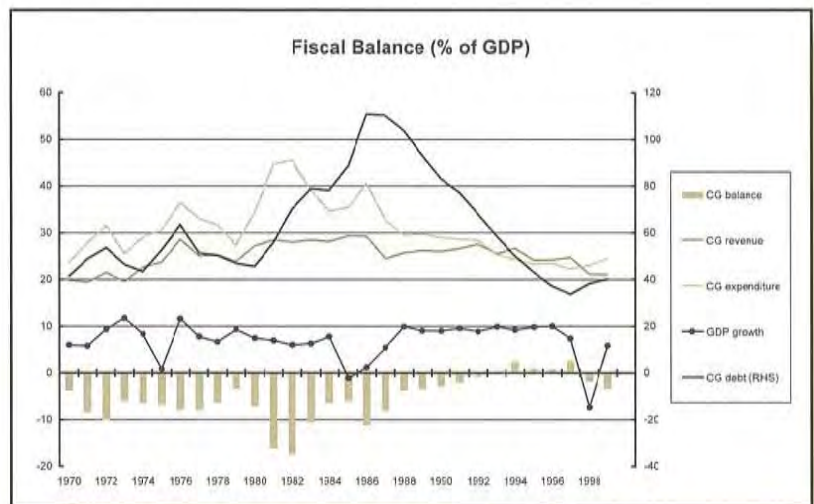
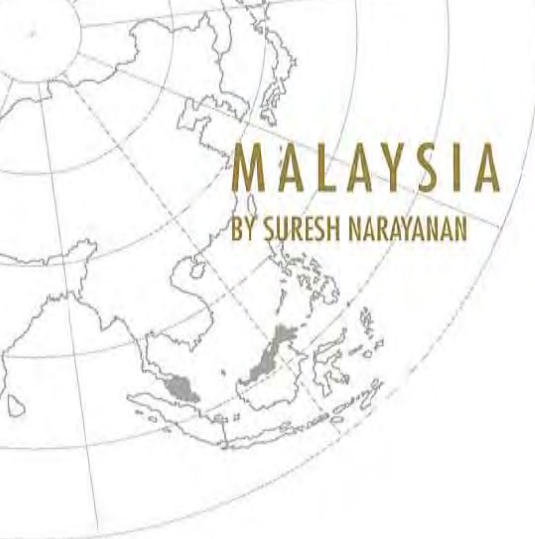
tives to firms and to stimulate private consumption.

Meanwhile, tax burdens in Korea are less than 20 percent of nominal GDP, which is much lower than any other developed country. However, Korea has numerous quasi-taxes ranging from a national pension, bribes, rebates, and money gifts to taxes that fund celebrations or funerals, etc. Thus, it is necessary to increase the transparency of the Korean economy and to change old and wasteful customs.

In the future, Korean fiscal policy should emphasize such policy targets as restructuring the budget system, continuing tax reform for stable revenue, and improving the public pension program. The Korean budget system could be summarized as a complex budget system. Since this Korean budget system could impede the efficient and transparent management of public monies, the number of special accounts and public and other funds should be reduced.

Korea has faced many difficulties such as the uncertain costs of economic cooperation with North Korea, spending pressures for the social safety net including the public pension system and the Protection of Minimum Living Standards Act, and the financial support to stimulate the recent business downturn and to further resources for restructuring unsound financial institutions. Therefore, the new role of fiscal policy in Korea should be to achieve a balanced budget, to limit public debt, to improve the efficiency of public money and to remove existing distortions in the tax system.

As the tax burden will need to increase in the future, it will be important to minimize existing tax-related distortions in order to avoid magnifying their negative effects. Korea has, in fact, made some progress over the past decades in reducing such distortions, in particular by broadening some tax bases and lowering tax rates along the lines followed in many other developed countries. It is imperative to continue the movement towards still greater neutrality in the personal income tax system and to avoid excessive use of taxes as instruments of industrial policy. The priority should be to broaden further the tax base for the personal and corporate income tax systems, as well as the VAT system.



Malaysian fiscal policy is conveniently analyzed by examining three periods: the first or the pre-National Economic Policy (NEP) period (1970–1979), the second or the post-NEP period (1980–1989), and the third period (1990–1999).

In the pre-NEP period, fiscal policy adopted a neutral stance; however, with the NEP and its stated objective of restructuring the economy in favor of the indigenous people (Bumiputera), fiscal policy became an important tool for achieving this objective in the post-NEP period. Crucial to the restructuring process was economic growth and counter-cyclical fiscal initiatives were seen to be essential for stabilizing the open Malaysian economy which is highly vulnerable to external demand changes. During 1974–1976, when external demand for Malaysian commodity exports weakened, there was an economic downturn. Government spending was increased, and fortuitously, external demand recovered as well. However, the fiscal effort was given credit for the rapid economic recovery.

In the early 1980s, when signs of a worldwide recession emerged, Malaysia appeared to insulate itself from the effects through a sustained spending policy and because it was still enjoying the benefits of the tail end of an export boom. However, with the recession failing to abate, the spending policy had to be abandoned in 1982. Government expenditures were slashed as the public sector lacked the resources to continue with the expansionary stance. Between 1980 and 1982, Malaysia had chalked up

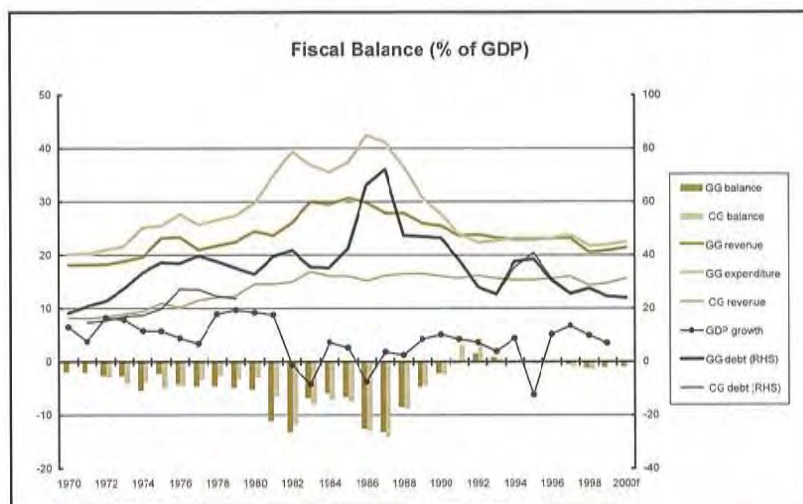
an external debt that rose from 9.5 percent to 27.0 percent of GNP, while the budget deficit had jumped from 7.2 percent to 17.5 percent of GNP. Moreover, the current account deficit of the balance of payments rose from 1.2 percent to 14.0 percent of GNP.

From 1984 to 1990, concerted efforts were made to downsize the public sector through expenditure cuts, privatization and the reduction of off-budget agencies. Measures were in place to revive the dormant private sector as well. These efforts were aided by favorable external developments. Export commodity prices recovered and the post-Plaza Accord period saw the relocation of Japanese and U.S. firms to Malaysia. By 1990, the economy had returned to a growth rate of 9.7 percent (from negative growth in 1985), the budget deficit was down to 3 percent of GNP, and the current account deficit had dropped to 4.2 percent of GNP. This economic momentum was maintained until the late 1990s when the financial crisis affected several East Asian countries including Malaysia.

The response to the 1997 financial crisis went through three phases: a tight fiscal and monetary stance, a tight monetary stance coupled with counter-cyclical spending, and, finally, expansionary monetary and fiscal policies. However, deficit spending during the last period was capped to a maximum of 6 percent of GNP, and the policy mix was aided by controls on short-term capital outflows and a fixed exchange rate regime.

The immediate impact of these policies was positive. The undervalued ringgit boosted exports while weak domestic demand reduced import demand. The net impact was a significant balance-of-payments surplus and an increase in external reserves.

However, the initial impetus appears to be wearing out and several challenges now need to be addressed. First, although the economy has gained valuable breathing space, an open economy like Malaysia cannot remain insulated by a fixed exchange rate system and capital controls. Although the capital controls have been largely dismantled, allowing the exchange rate to reflect market forces is a greater issue that is being postponed. Second, other factors can impair the recovery process. The health of economies such as the U.S., Japan and Europe are a cause for concern since they are major markets for Malaysian exports; foreign investment inflows are critical and appear to have moderated; and domestic investment activity and confidence remain low. Unless improvements are forthcoming on all fronts, the public sector may end up shouldering the burden of recover—a responsibility it cannot sustain indefinitely. A prolonged anti-cyclical effort will require recourse to foreign loans and a debt burden that is more difficult to contain. Finally, there is an urgent need to streamline and revitalize the indirect tax system so that revenue collections are maximized.



In order to properly understand fiscal issues in Mexico, it is necessary to take into account some important institutional features of the structure of the Mexican government. In spite of being a federal republic, fiscal accounts are highly centralized in Mexico, particularly in terms of revenue. Moreover, the revenue side of the central government's balance sheet displays a very low proportion of tax-related earnings: in the 1970–2000 period, for example, tax revenue never exceeded 16 percent of GDP. The former is explained by a high reliance on oil revenue, where the public sector maintains exclusive ownership. Although expenditure has been increasingly decentralized, lower levels of government are still highly dependent on resources transferred from the federal government.

Along with the operational distinction that emphasizes expenditure related to interest payments on debt, this dependency complements the background on which definitions of public balance and debt should be placed. Regarding the former, two concepts stand out: the economic balance (i.e., the sum of central government plus SOEs) and the primary economic balance (where interest payments on debt are subtracted). At the end of the period under analysis, both measures were very close to balance, and the ratio of public debt-to-GDP was 24.8 percent in 1999, one of the lowest among OECD nations. However, when international guidelines are abandoned in order to take into account all future commitments, estimates of debt to GDP reach 135.9 percent, once contingent debt — mostly

from pensions of private and public sector workers — is taken into account. In this respect, Mexico is no different from other OECD members, which, in turn, leads to important questions regarding the validity of current international guidelines on measuring public debt.

The former elements define dilemmas of fiscal balance. But Mexico's status as a middle-income country with high levels of poverty means that focusing on the former while ignoring the potential contribution of the government to social well-being leads to a very partial picture. The answer to the question "what should governments do?" constitutes a decision of the whole society based on normative judgments, where a potential trade-off between the aims of fiscal and social balances arises. With the help of a very simple theoretical framework, these two aspects are incorporated into our analysis of the 1970–2000 period in Mexico. Three qualitatively different stages can be distinguished and are examined in further detail below.

The first period, 1970–1980, is referred to as "the state option." During this period, the level of government intervention in the economy is reflected in the growing number of SOEs which rose from 84 in 1970 to 1,115 in 1982. In the absence of market discipline, these SOEs displayed an endogenous bias to losses, which cancelled out a timid advance of tax revenue to GDP (from 8.1 percent in 1970 to 15.0 percent in 1980). High oil prices in the 1970s preserved this soft budget constraint via indebted-

ness, but led to two critical vulnerabilities: foreign debt reached US\$58.1 billion in 1982 and oil revenue increased from 0.65 percent of total public revenue in 1970 to 32.0 percent in 1982.

Given the former conditions, higher international interest rates at the beginning of the 1980s and falling oil prices led to the Leviathan (1981–1990), the second period of analyses. The growth of fiscal deficits became endogenous as: (1) the financing of public debt in the internal capital market meant a crowding out of the private sector and an increase in local interest rates, which in turn, led to (2) even higher fiscal deficits and (3) growing inflation which — via nominal interest rates — completed the vicious circle. The entire decade was spent combating the Leviathan via the following policies: (1) dismantling of the SOE sector, (2) reduction in government expenditure in areas such as investment and education, and (3) increases in tax-related revenue.

Implementation took place in an environment of urgency and difficult social and political conditions. Problems such as the excessive centralization of government decisions and the uneven and irregular fiscal structure that are still present in Mexico today are the result of the compromise between these fiscal and socio-political factors.

The third period is the “market option” period, 1991–2000. Fiscal discipline and small government in this stage have led many to view Mexico as an example of fiscal virtue based on learning from its past mistakes. Nonetheless, this view underestimates problems on the revenue side. First, the tax structure contains inconsistencies derived from the need to simultaneously fulfill the opposed aims of efficiency and income distribution. As a consequence, tax collection (which was 10.5 percent of GDP on average during the 1990s) is one of the lowest among the OECD countries and dependence on oil revenue remains extremely high (at 33 percent of total revenue between 1991 and 1999). This situation implies costs in terms of the macroeconomic efficiency of fiscal policy and the ability of the state oil company to operate with managerial criteria. Given a strict restriction of the fiscal balance and former limitations on revenue, the adjusting variable has been on the expenditure side. Again, and given Mexico’s socio-political

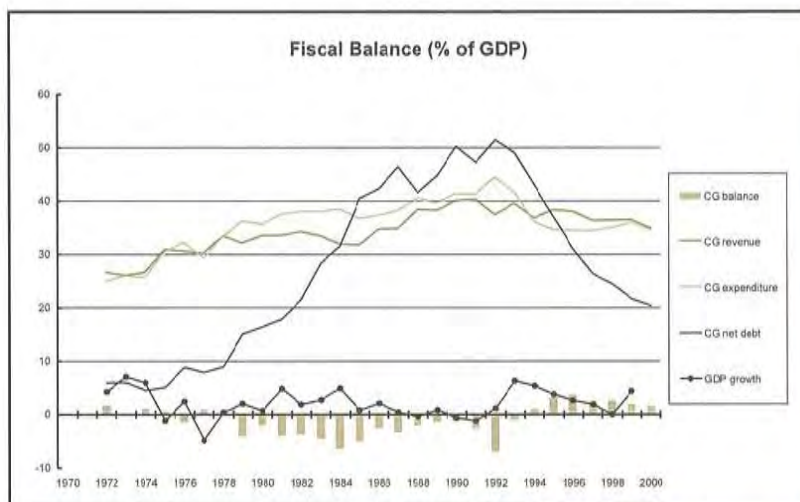
context, these circumstances imply a serious deficit in terms of the social balance.

Faced with this dilemma, the only option for the Mexican government during the 1990s has been to “spend better.” Efforts in terms of enhanced efficiency of public administration, decentralization and social expenditure are explored at greater detail in the background paper. Experiences in each of these areas show that the right balance between fiscal consolidation and the redefinition of the role of the government in the economy is far from being a settled issue. Although Mexico enters the 21st century with a series of basic consensus in terms of the need for fiscal equilibrium, it is also agreed that the government still has an important role to play in a market-oriented economy and that the actual instruments employed by the state to perform its duties are a critical matter. In particular, a distinction between the aims of tax (efficiency) and expenditure (distribution) policies is seen as essential. Last, but by no means least, more public investment in areas such as health, education and the fight against poverty is seen as imperative; Mexico’s ratio of government expenditure to GDP (20 percent) is well below the OECD average (45 percent). Given the commitment to fiscal equilibrium and sound financing of expenditure, more tax revenue is the only viable way to meet these requirements.

The lessons of a 30-year cycle on fiscal issues in Mexico are reflected in current efforts to implement a comprehensive fiscal reform. Perhaps the most important of these lessons is that, rather than being a technical issue, its approval depends on political choices — that is, society as a whole making a normative decision about the role the government should play on the promotion of economic development and well-being.

NEW ZEALAND

BY DOUGLAS STEEL
PETER GARDINER



This paper discusses the development of fiscal policy in New Zealand over the past 30 years. There have been two distinct episodes in fiscal policy for this period: 1970–1984 and 1984–present. During the first episode, fiscal policy was dictated by a traditional Keynesian view. Successive governments endeavored to manage the New Zealand economy by expanding the role of the public sector and real-locating New Zealand’s resources to fit policy objectives.

In the 1970s, fiscal policy focused on economic growth. However, oil shocks in 1974 and 1979 undermined world demand and New Zealand’s economic performance fluctuated. A sharp decline in the terms of trade following the oil shocks caused the current account deficit to grow. The response of the government to the oil shocks was to introduce policies emphasizing export promotion, import substitution, and self-sufficiency.

These economic growth policies achieved some success, but other problems emerged including inflation and fiscal deficits, as the tax cuts placed pressure on the fiscal and current accounts. By 1984, government expenditure had grown to 38.3 percent of GDP, up from 24.9 percent in 1972, and the fiscal deficit had expanded to 6.5 percent of GDP. Significantly, government debt had reached high levels, unemployment and the current account deficit were growing, and a currency crisis provided the catalyst for a substantial deregulation of the New Zealand economy over the years to follow.

The reform program that began in 1984 saw a stark change in economic policy. There was a move away from protectionism, market intervention, and control, towards a more liberal, market-oriented economic environment. The scope and depth of the reform program was larger than that experienced by most other countries. Focus was more on implementing stable policies rather than stabilization policies, and emphasis was on adopting policies that would be sustainable in the longer term. As part of the shift in policy direction towards reducing government intervention and allowing markets to allocate resources, fiscal policy was directed initially to achieving internal balance and later to repaying debt.

The road to restoring fiscal balance was a long and winding one. A broadening of the tax base helped to increase revenue. Expenditure, as a percentage of GDP, rose over the 1985–1991 period, as debt financing costs and social welfare payments (partly due to labor shedding by newly formed state-owned enterprises) rose. The persistent fiscal deficits were fully funded by issuing bonds, leading to rising debt. Part of the revenue generated from sales of some state-owned enterprises was used to retire debt.

Following a major correction in world and New Zealand equity markets in 1987, revenue growth slowed. This postponed the targeted fiscal balance that the policy had set out to achieve. Cuts to social welfare benefit rates and tighter eligibility

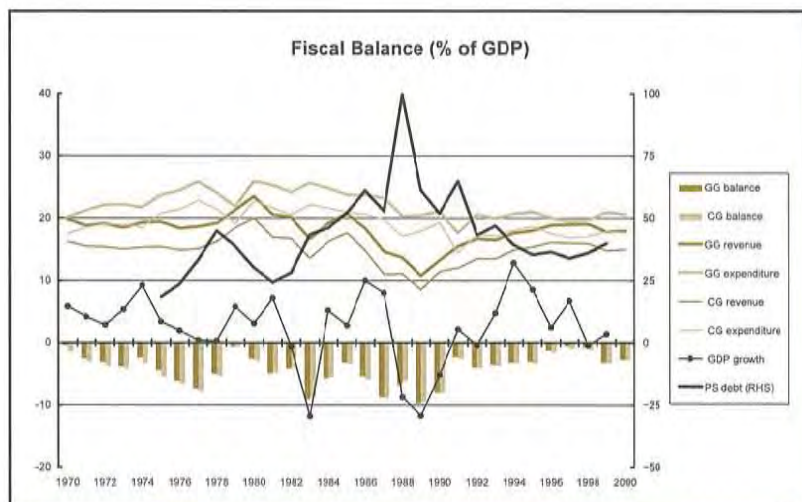
criteria for receiving benefits in the 1991 budget — which came to be known as “the mother of all budgets” — had a major impact on expenditure.

Legislation aimed at improving efficiency in the public sector was introduced in the late 1980s. This included the State Sector Act (1988) and the Public Finance Act (1989). The Fiscal Responsibility Act (1994) was aimed at making fiscal policy more transparent to increase accountability and to reduce uncertainty surrounding the longer-term future of fiscal management.

A fiscal surplus was achieved in FY94, and by 1996, the fiscal surplus was 3.6 percent of GDP. Continued surpluses have subsequently been used to pay off debt, first to the foreign currency debt followed by New Zealand dollar debt.

More recently, the coalition government formed after the November 1999 election has shifted the direction of fiscal policy away from the free-market philosophy that had been followed in the previous 15 years. A freeze on tariff reductions and an increase in the top marginal tax rate are among many of the changes made by the new government. The impact of these and other changes on the fiscal situation are not yet clear.

Perhaps the most important fiscal policy issue in New Zealand today surrounds superannuation. The government intends to build a fund to partially pre-fund future New Zealand superannuation. However, the fund and its governance arrangements will not be formally established until the New Zealand Superannuation Bill is passed.



The paper analyzes the main fiscal policy issues occurring during the last decade in Peru, which is presented in three different stages. The first period (1990–1997) starts when the Peruvian government launched an aggressive stabilization program aimed at liberalizing and deregulating the Peru economy that was immersed in a severe hyperinflation process, had almost no international reserves and was isolated from international financial markets. Under a successful stabilization process supported by fiscal and monetary discipline, inflation was reduced from 7,650 percent to less than 7 percent, international reserves increased from US\$510 million to more than US\$10 billion, and due to a strong fiscal policy, the fiscal imbalance plunged from 8.7 percent of GDP to an overall surplus of 0.2 percent of GDP in 1997, the first fiscal surplus in more than 35 years.

The second period — which extended from 1998 to the first half of 2000 — is characterized by an economy facing external financial shocks and natural disasters, which finally were translated into demand recession and a drop in tax collection. In addition to the effect of the recession on revenue, fiscal discipline was affected by an increase in both central government expenditure and in tax benefits arising from pursuit of a countercyclical policy. All of these events provoked a performance that could create a serious fiscal imbalance and unsustainable fiscal situation in the medium term.

Under such difficult circumstances, since the sec-

ond half of 2000, the current government has begun an emergency fiscal program to restore the fiscal accounts in a sustainable way through expenditure reduction and restoration of an active tax policy that is focused on gradual elimination of tax benefits and reduction in both tax evasion and tax elusion.

Four developments in fiscal policy during the last ten years in Peru and some selected issues regarding fiscal policy are summarized below.

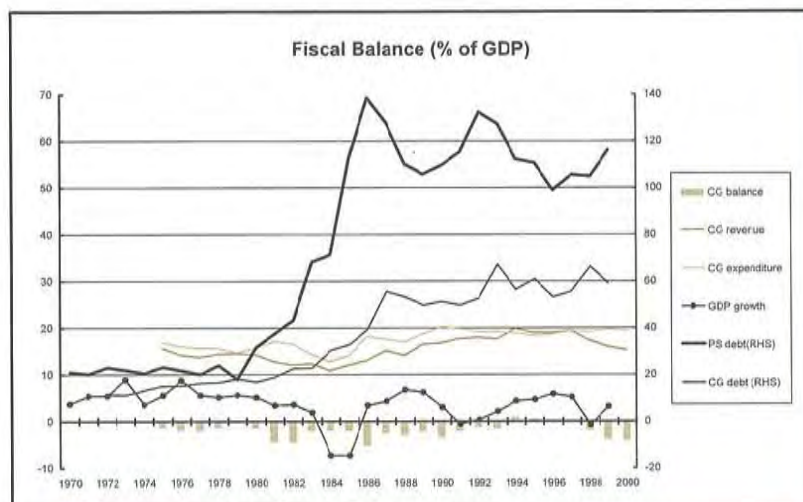
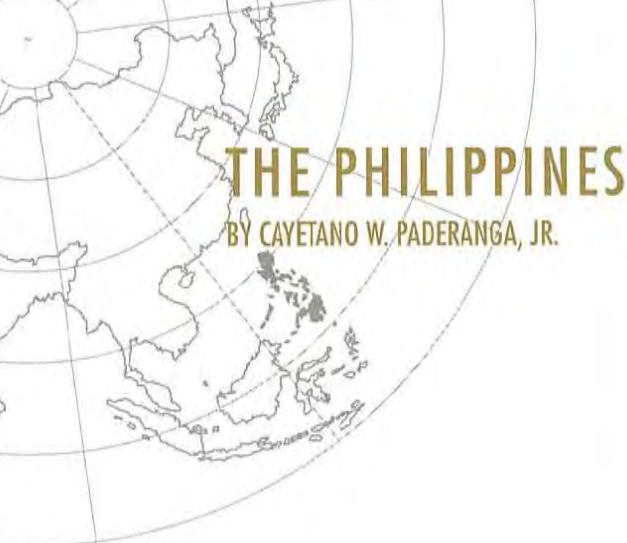
Tax reform carried out through the first years of this decade was successful in terms of providing greater tax collection, strengthening fiscal policy of the government, and correcting the fiscal accounts. The main modifications introduced were on tax rates and brackets which decreased income taxes on individuals and corporations, eliminated deductions and exemptions, and improved tax administration.

Through privatization, the Peruvian government changed public assets into private ones in order to improve both economic efficiency and the fiscal position. The effects of the privatization process were multiple, at both the macroeconomic and microeconomic levels, contributing to economic stability and permitting an increase in the productive capacity of the country.

Pension system reform was launched in 1996 to ensure an efficient retirement pension scheme and

to promote domestic saving, while increasing the available resources to finance investments. The Fiscal Responsibility and Transparency Law enacted in late 1999 was aimed at contributing to economic stability and economic growth through a sound fiscal framework for the medium term. The Law restricts the fiscal deficit of the consolidated public sector, limits the growth of nonfinancial expenditure of the general government, and establishes a stabilization fund intended for current income fluctuations associated with the business cycle.

A full description of how the fiscal deficit is measured and its drawbacks as a fiscal sustainability indicator is provided in the background paper. The paper also explains in greater detail several alternative indicators, and discusses the main policy issues related to public debt management in order to ensure financing and repayment obligations. Finally, the paper describes what is expected in the following years with regard to fiscal policy: actions that restore the financial balance without affecting the economic recovery or subtracting resources required by the private sector.



The Philippines has had a volatile economic record for the last two decades. During this period, the country experienced a deep recession in 1984 and two relatively minor recessions in 1990 and 1997. A major cause and effect of this overall volatility is a deterioration in the government's fiscal position. The national government's fiscal position has mostly been in deficit since 1975 with the exception of surpluses recorded in 1994–1997. The large deficits can be traced to a large revenue shortfall and rapid implementation of large public investment projects. In recent years, foreign borrowing has financed the large fiscal deficits to a significant extent.

The continued structural deficit introduces an underlying instability into the system that reduces the Philippine economy's ability to absorb external and random internal shocks. At the same time, economic volatility introduces uncertainty into the tax base, reduces stability and predictability in the taxpayer's ability to pay, and may unduly complicate the collection process. This underlying interaction argues for structural changes designed to reduce volatility and create a stable fiscal balance.

In the past 15 years, the Philippine government has implemented various changes in its revenue and expenditure patterns. It initiated a series of attempts to overhaul the tax system such as the Local Government Code in 1991, which increased the local government's share of internal revenue taxes and their power to impose fees and taxes.

The local government and national government's share of GDP increased and slightly decreased, respectively, in the last decade. On the whole, the Philippine tax effort has generally been disappointing compared to other countries in the ASEAN region. Improvement in tax effort in the late 1990s remains insufficient to finance the financial operations of the government. The move towards direct taxation in the 1990s turned out to be more beneficial as the greater tax burden was redirected toward household groups that had a greater ability to pay.

The experience of most countries suggests that domestic indirect taxes progressively replace foreign trade taxes. In the Philippine case, internal indirect taxes as a percentage of GDP have been fairly constant. Therefore, unless collections from direct taxes are aggressively improved, the government's revenue collection will not be able to catch up with the size of its spending. On the other hand, non-tax revenue distorts the long-run fiscal picture of the government. With lower net worth, the government is in a weaker position to service fiscal deficits in the future.

The national government's fiscal expenditure suggests that, as a percentage of GDP, it has been tracking the country's growth path. However, the share of capital expenditure in total government spending is continuously being reduced, suggesting serious underspending in physical infrastructure. Meanwhile, the amount of spending that is directed toward the servicing of liabilities of the public sec-

tor has continued to escalate.

In a period of stabilization, the government's immediate aim should be to close the fiscal gap in the short run. Nonetheless, in a process of recovery, which the Philippines is undergoing at this time, a higher growth path should be achieved by attaining fiscal balance but not at the expense of investments in infrastructure and human capital.

One of the reasons for the failure of the Philippine economy to grow on a sustainable basis is its inability to accumulate savings to finance its public investments. This slow accumulation of savings by the public sector has been offsetting the high saving levels achieved by the private sector, resulting in a widening of the savings-investment gap.

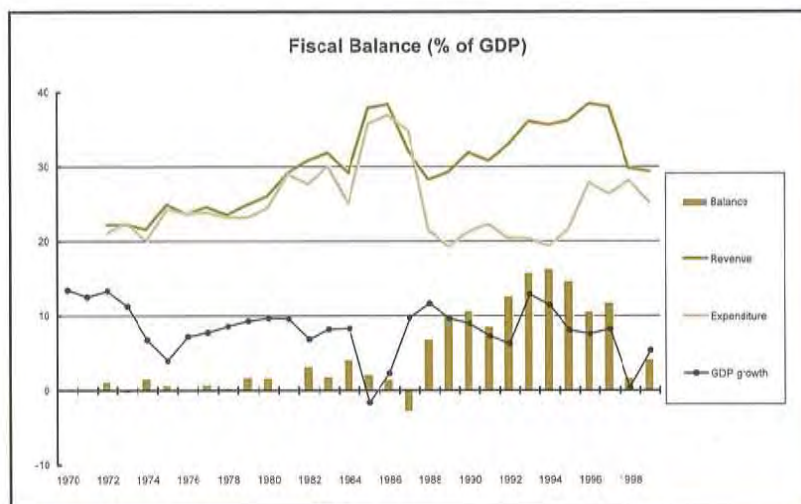
In the years 1999 and 2000, the stagnation of tax buoyancy implies that increases in economic activity lead to a much lower percentage in tax revenue, contrary to what the literature suggests.

One of the major threats on the long-term fiscal position of the national government is its large stock of outstanding debt and the costs of servicing that debt in the long run. Meanwhile, the debt ratio has been on an upsurge since the early 1980s. The rapid expansion in government expenditure in the period 1986–1993 does not reflect an inordinate growth in the size of the government, but is attributable to a large debt service, which hampered the government's capacity to leap the economy into a higher-growth orbit.

The social service sector continues to capture the largest share of aggregated government expenditure, of which education is the largest recipient. However, government spending for economic services, especially infrastructure, is continuously being cut and this has created major bottlenecks in the economy. In contrast, the large share of general public services has been fairly stable. The rising allocation for general public services and the decreasing budget for economic services suggest a weaker contribution of the government to sustainable growth. It would appear that the national government is spending more in areas that are less important and less in areas that are crucial for sustaining economic growth.

To raise its sustainable growth rate, the Philippines needs to close its fiscal gap without sacrificing essential physical, social and human capital investments. The government's move to indulge in deficit spending in an attempt to stimulate the economy out of a mild recession during the Asian crisis has put its fiscal stability in jeopardy. The government's low tax collection effort has resulted in an unsustainable public debt level and low saving rate of the country.

On the revenue side, the inability to collect direct taxes has resulted in an overdependence on indirect taxes. The government must reform its tax administration and abolish complicated taxes. It must also reduce personnel services, red tape and bureaucratic lethargy. These structural reforms will require tremendous effort, political will and commitment; but only then can the fiscal area be conducive to sustainable rapid growth.



Singapore's budgeting principles is reflected in the prudent resource management and accumulation of a financial buffer that the country has consistently pursued over the last three decades with growth in GDP averaging 8 percent per annum. Being an external demand-driven resource-poor island economy with a small population base of 4 million people, it is understandable that the Singapore government has always insisted that total expenditure be contained within the scope of operational revenue in every annual budgeting statement, except during years of economic hardship which tend to last no longer than two years. Such prudent and surplus-oriented budgeting principles mean that the republic does not need to rely on foreign aid or incur foreign debt in pursuing economic and social development. Evidence of the continued commitment to such budgeting principles is seen in a constitutional amendment introduced in 2001 that requires the government to protect at least 50 percent of net investment income earned from past reserves; the "dual-key" approach means that any draw down of past reserves by the ruling government needs the approval of the republic's publicly elected president, which in turn implies a generational impact with intertemporal implications.

As government surpluses continue to rise, especially since the late 1980s right through to the new millennium, various ministries and statutory boards are being funded through strict budgeting allocations. In 1994, the Ministry of Finance launched the Budgeting for Results (BFR) initiative with the

intention to improve financial management in the public sector. Following the principle of BFR, 14 organizations were commissioned as autonomous agencies (AAs) in April 1995. In 1996, another 102 ministry headquarters, departments and government-funded statutory boards (SBs) are being managed as AAs. This move is intended to provide the entire civil service and all SBs with "greater autonomy and flexibility to respond quickly to changes, along with incentives for efficient and superior performance and the wherewithal to nurture enterprise and creativity" with the ultimate "objective of creating a leaner, more efficient and enterprising public service."

Notwithstanding the proposed good intentions, some have expressed concern that the financial management reform under the BFR initiative could lead to increases in the price of public services or create a profit-oriented mindset in government without regard to the larger goal of providing quality public services. As a result, the BFR initiative — which essentially is based on giving more resources on the promise of increased output — was replaced in 2000. The original argument behind the BFR initiative was that a more efficient public sector would be better placed to moderate price increases, and any unjust price hike or profit-oriented motive would be closely monitored by the authorities. However, the Finance Minister conceded in his 2000 Budget Statement that the BFR initiative "has the tendency to get the Ministry of Finance involved in the micro management of the

ministries.”

As a result, a new budgeting paradigm shift was proposed in February 2000, from the BFR initiative to one of Budget Resource Accounting (BRA) by “encouraging ministries to get the most out of their allotted resources. Within that budgetary framework, ministries are assured of a built-in increase for their base budget that is dependent on the GDP growth rate. Any increase in budgetary provision beyond that would have to be justified on the basis of the priority of their programs against others.” This BRA principle is a fine-tuning of the previous BFR initiative since ministries are now being encouraged to not just look at the output generated by their programs, but also to examine the desired outcomes that the programs were intended to achieve. It was further proposed that over 2001 and 2002, further concepts pertaining to BRA would be introduced to ensure that ministries look at the total cost of providing services rather than just the cash cost alone. Among the major implications under the new BRA principle is that the forecast of GDP growth—which is traditionally provided by the Ministry of Trade and Industry—becomes a crucial input into the budgeting process. The inability to provide reasonably accurate economic growth forecasts could not only deny or overprovide resources to various ministries, but it could also distort projected revenue and hence the overall budgetary balance projection.

The size of the government in Singapore, as measured by government expenditure as a percentage of GDP, was slightly below that predicted for a country at Singapore’s level of per capita income in 1980. By 1998, public expenditure had fallen to a level that is significantly lower than that predicted on the basis of per capita income. The same trend is noted in the share of tax revenue in GDP. However, it is well-known that the influence of the Singapore government in economic activity extends beyond the central government’s finances. A significant part of the government’s functions is, in fact, channeled through statutory boards. These are semi-autonomous agencies that were started in the 1960s to handle specific concerns, initially in the areas of housing and economic development, and subsequently in almost every important economic and social field. In addition, there exists various government-linked companies which are

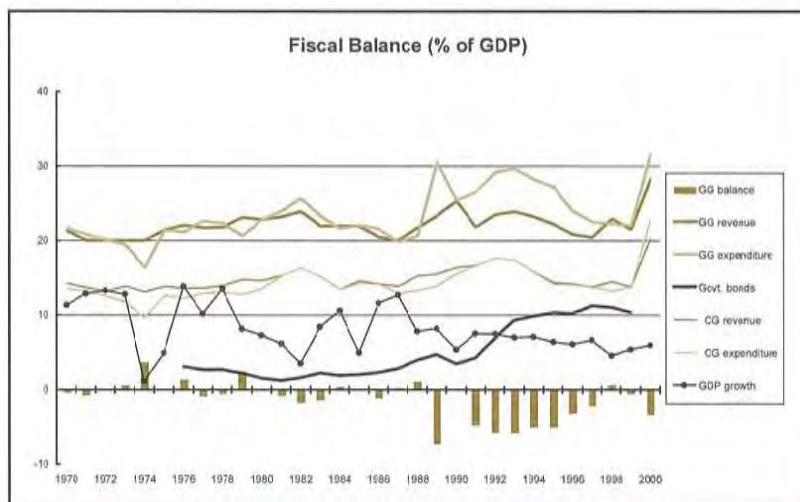
incorporated entities that are either wholly or partly government-owned, and these are found in a wide range of basically private sector activities, including manufacturing, shipbuilding and ship repair, trading, financial services, construction and property development, tourism and leisure. The share of these two sectors is large, although they have been declining as a result of privatization and as the government has been divesting its share in GLCs, in line with its objective to give the private sector a greater role in the economy.

Development expenditure in the areas of security and defense, infrastructure projects in terms of transportation and information technology, human resource investment in education and retraining of workers, and enhancement of life style and quality of life in terms of environmental preservation and cultural enrichment have and will continue to receive heavy government funding. Over the longer term, we should continue to see the size of government shrink from the current 6 percent of the operating expenditure-to-GDP ratio, with the income tax revenue burden being capped at 8 percent of GDP, while policies that shift from indirect income tax to direct consumption tax in order to promote high savings will continue.

In the face of the aging Singapore population, the strategy is to move the burden of public healthcare and the social security net towards a private sector-based co-payment cum co-responsibility sharing system. By promoting Singapore as a regional headquarters for multinational corporations and a financial and port services hub for the region, the republic has made continuous attempts over the years to provide profit tax rebates for large financial institutions and the low corporate income tax at 24.5 percent is now ranked as the third-lowest in the world. The aggressive foreign talent recruitment policy will help to revitalize the republic’s increasingly globalized economy and mitigate somewhat the aging population profile as the country moves towards the population target of 5.5 million by 2015.

CHINESE TAIPEI

BY RONG-I. WU
CHENG-MOUNT CHENG



In recent years there has been a dramatic change in the government's fiscal balance. Before 1989, the general government basically maintained a balanced budget, while at the same time, economic growth was sustained at a high pace. However, beginning in 1989, the central government's fiscal deficit enlarged to a great extent.

To prevent the fiscal deficit from running wild, the central government passed the Public Debt Law in 1994. This law stipulates that the outstanding debt for the general government must not exceed 48.0 percent of the average GNP of the previous three years, and the outstanding debt for the central government must not exceed 28.8 percent. Moreover, the fiscal deficit of the general government must not exceed 15.0 percent of the expenditure budget in the current fiscal year.

There are currently four layers of government in Chinese Taipei: the central government, the provincial and municipal governments, governments of counties and cities, and township offices. The central government has a dominant role in terms of revenue and expenditure of the general government. For instance, in FY76, the central government's revenue and expenditure reached NT\$96.2 billion and NT\$87.0 billion, respectively, representing 53.3 and 52.3 percent of revenue and expenditure of the general government.

In 1999, the Taiwan provincial government was streamlined. As a result, the share of the central

government's revenue and expenditure relative to that of all governments jumped to 65.3 and 66.5 percent, respectively, in FY00. Meanwhile, the share of the Taipei and Kaohsiung governments remained at 10.8 and 10.3 percent, respectively. However, the share of local government's revenue and expenditure also increased to 23.8 and 23.2 percent, respectively.

Under the Chinese Taipei tax structure, the central government collects the income tax, customs duty, commodity tax, security transaction tax, future transaction tax, mining lot tax, distribution tax and so on. Tax revenue for the municipal and the provincial governments is derived from the business tax, stamp tax, license tax, distribution tax and harbor construction dues. Tax revenue for county and city governments is obtained from the land tax, house tax, slaughter tax, amusement tax, deeds tax, education surtax and distribution tax.

To address the asymmetry in the collection and distribution of tax revenue among the different levels of governments, the central government revised the Fiscal Distribution Act in 1999. Under this Act, each layer of government must draw up a program and raise the required funds before it launches a construction project or before it starts to provide services. To match up the fiscal year (which begins in July and ends in June of the following year) with the calendar year, the government extended the fiscal year 1999 to the end of December 2000 such that FY01 will begin in January and

end in December 2001.

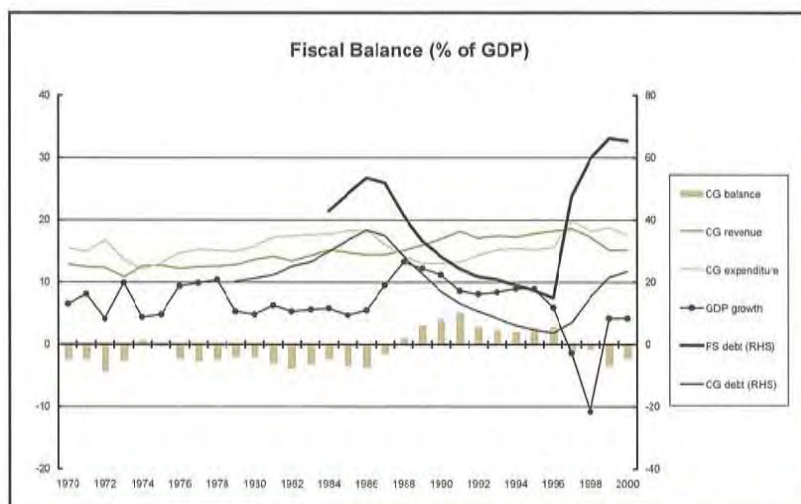
The ratio of tax revenue to total government revenue has been declining, reflecting the government's increasing reliance on other sources, especially finance on the capital account, to increase government revenue.

Spending on defense was the largest item of government expenditure before FY75. Subsequently, expenditure on economic development jumped into the fore. Then in FY96, expenditure on social security took the lead. This shows that the government's policy priority has switched from defense to economic development and now to social security.

With the exception of FY80, proceeds from issues of public bonds have been a major source of financing for the government, representing as high as 184.3 percent and as low as 19.8 percent of net borrowing. Another source of financing is from loans for economic construction, and the importance of this source of funds has been rising in recent years.

Only the central government and the provincial and municipal governments have the right to issue public bonds. In FY85, the ratio of outstanding debt to central government's expenditure was only 12.3 percent, but this had risen to 94.3 percent in FY99. At the same time, the ratio of outstanding debt to GNP also rose from 1.8 percent in FY85 to 14.7 percent in FY99.

Currently the government faces four challenges in the area of fiscal policy. These challenges are: (1) continued increase in the fiscal deficit; (2) asymmetry in the distribution of revenues between central and local governments; (3) poor structure in the government's revenue; and (4) debt management.



Thailand is still in the painful process of emerging from the largest economic crisis in a generation, a crisis that strained the country's public finances and fundamentally changed the environment in which it manages. After a decade of surpluses, Thailand faced recession-induced lower revenue, rising social expenditure, costly restructuring of the financial sector, rising government expenditure to stimulate domestic demand, and consequently higher public debt since 1997. The government budget has been in deficit since then and is likely to be in deficit for the next 3–4 years, as government expenditure will continue to increase to sustain the economic recovery, resolve social problems, and build a strong foundation for the economy.

The financial and currency crisis in mid-1997 had a severe impact on the Thai economy. After experiencing real average annual growth rate of over 9 percent between 1986 and 1996, real GDP contracted by 1.4 percent in 1997 and 10.8 percent in 1998. With this sharp decline in GDP, the government needed to take significant measures to stimulate the economy, and given conditions that were prevailing during much of 1998, the role of stimulating the economy fell largely on fiscal policy. First, commercial banks were not functioning normally at that time because of the large share of nonperforming loans and the financial crisis, and this made monetary policy less effective as a means of stimulating the economy. Second, the other components of aggregate demand had con-

tracted and were unlikely to increase substantially at that time. The economic crisis had affected much of Asia, which represented over 50 percent of Thailand's export market, and strong increases in export demand were therefore not promising. Moreover, overinvestment in the past had led to excess capacity, which made large increases in private investment demand also unlikely. Additionally, decreased personal income and rising unemployment had reduced private consumption demand.

Government spending thus represented the most effective means of stimulating the economy. Hence, the government has continuously relaxed its fiscal stance and increased the overall public sector deficit, as indicated in each Letter of Intent (LOI) signed with the International Monetary Fund. The overall public sector deficit for FY98 was increased from a surplus of 1 percent of GDP, as indicated in LOI 1, to a deficit of 3 percent. For FY99, the overall public sector deficit was 4.7 percent of GDP. This includes the impact of the additional expenditure, tax, and energy price reduction measures designated in the March 1999 economic stimulus package.

Government measures to resolve the crisis have since significantly improved the macroeconomic situation. Real GDP increased by 4.2 percent in 1999 and 4.4 percent in 2000. However, since the latter half of 2000, Thailand has experienced a cyclical downturn in some major export markets

such as the U.S. and Japanese markets, while private consumption and investment have yet to fully recover. Thai exports, one of the main contributors to economic recovery in 1999 and 2000, are likely to contract in 2001. Given these market conditions and the poor public sentiment, it remains imperative for the government to increase spending to sustain the economic recovery. Government expenditure was set to increase in FY01 and FY02 from FY00's deficit. The continuing budget deficit and trend in government expenditure during the financial restructuring will result in an increase in public debt, which is expected to reach its peak in the next 1–2 years, when the loss of the Financial Institute Development Fund (FIDF) is materialized and partly fiscalized.

Relying on fiscal stimulus has, therefore, prompted three main concerns. First, the crisis has substantially increased the stock of public debt, which raises concerns over fiscal sustainability and Thailand's resilience to future shocks. Second, following the crisis Thailand switched to a flexible exchange rate regime, under which the effectiveness of fiscal policy is questionable if capital is fully mobile. Whether this concern is valid depends on the degree of capital mobility in Thailand and whether the flexible exchange rate regime is a free-float or a managed one. Third, the economic crisis has revealed weaknesses that were obscured during the boom years.

The fiscal challenges that emerged from the crisis consequently call for fiscal reform and concerted effort in several interrelated areas. These reforms must emphasize accountability and transparency, and changes in financial management and reporting, and service delivery. In addition, the reforms should also include the decentralization of government activities to local administrations, which is mandated by the new Constitution that was inaugurated in 1997. The challenging tasks associated with these reforms are as follows.

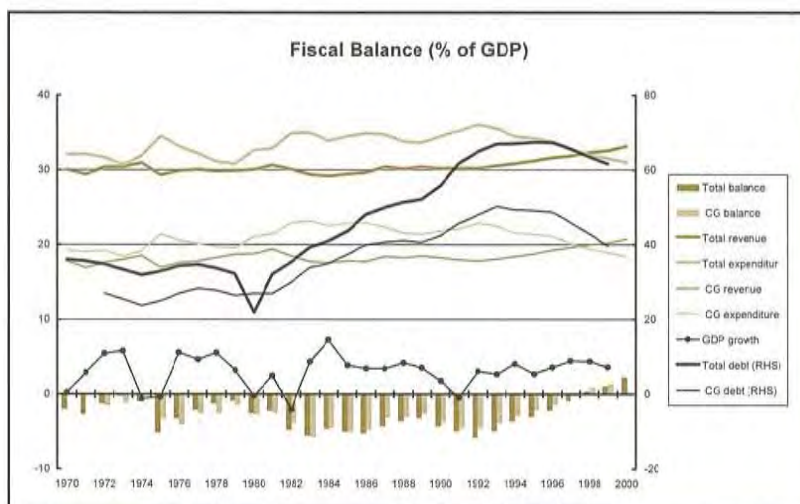
First, improvement in public debt management and revenue administration is needed to be more efficient and ensure fiscal sustainability. Asset disposal and privatization are also included in the agenda so that provision of public services and utilities is managed more efficiently and the debt burden on the government is reduced. Second, the govern-

ment's capacity for prioritizing and targeting public expenditure must be strengthened. Third, the reforms must ensure more efficient fiscal management by moving to a performance-based and transparent management of public expenditure and revenue. Finally, decentralization of responsibility and accountability to local administrations is being carefully undertaken.

Restoration of fiscal strength and efficient utilization of fiscal policy as a demand management tool to provide for a healthy macroeconomic environment will certainly depend on the efficiency with which the above-mentioned challenges are managed. Generally, Thai fiscal policy can be characterized as one of fiscal conservatism. The government is legally restrained from running a large deficit, and fiscal policy has traditionally played a stabilizing role on the economy. That is, fiscal policy can be viewed as largely pro-cyclical; it ran a surplus in high-growth years and a deficit in slow-growth years. The expenditure allocation reflects development priorities. The evident also suggests that in the Thai case, cutting budget expenditure was much easier to achieve than otherwise. On the revenue front, the share of direct taxes has increased while that of indirect taxes declined as the economic system has become more sophisticated and liberalized. However, the share of indirect taxes remains dominant. During the crisis, tax collection declined significantly due to a decrease in economic activity. The need to increase revenue to be more in line with expenditure, therefore, reaffirms the government's urgent need to improve its tax administration to achieve a transparent, fair, nondistortionary, and cost-effective managed tax system. Under the best scenario, the government ambitiously aims to achieve budget balance by 2006, the last year of the Ninth National Economic and Social Development Plan.

THE UNITED STATES

BY JEFFREY B. NUGENT
ROBERT DEKLE



A decade ago, the fiscal deficits of the United States were very sizeable, causing interest rates in the U.S. to rise in order to attract capital from abroad to cover its twin deficits, crowding out of private investment and R&D expenditures at home, and, in turn, a lowering in productivity growth. Not only was this failure seen as a cause of the Third World debt crises of the 1980s, but it was also viewed as a severe distortion in the normal pattern of net capital outflows for an advanced industrial country.

In recent years, however, the U.S. has not only eliminated its fiscal deficits but seems poised to generate fiscal surpluses for the next decade. Growth in productivity and GDP have accelerated (at least up until the end of 2000) and inflation remains fairly low. The turnaround has been much more marked at the federal level than at the state and local levels. Indeed, state and local government expenditures have increased from 9.1 percent of GDP in 1960 to 12.8 percent in 1975, before declining gradually to 11.4 percent of GDP in 1999. Since state and local governments are quite frequently limited in their ability to run deficits, state and local governments have seldom contributed very substantially to the overall fiscal deficit.

This paper attempts to identify some of the most important determinants of this rather remarkable turnaround in the federal budget balance. One factor has been sharp and steady reduction in the level of military expenditure relative to GDP. Military

expenditure increased in the late 1960s during the country's involvement in the Vietnam War, but then declined in the aftermath of that war until the buildup of the 1980s. The peak occurred in 1987. Since then, military expenditures as a share of GDP has fallen by 3.5 percent between 1987 and 1999. Since at the beginning of the period under investigation, military expenditure accounted for over 10 percent of GDP and some 80 percent of total federal expenditure, this reduction was important. However, since this source of deficit reduction is attributable in large part to the disintegration of the Soviet Union and its reduced military threat, this lesson of experience may be far from generally applicable.

Several other factors, however, seem considerably more applicable to other countries. One of these is welfare reform that has helped to reduce the unemployment rate and welfare expenditure. Chief among the welfare reforms have been the adoption of stricter rules for receiving welfare payments and reductions in the tax disincentives for leaving welfare rolls in favor of employment at low wage rates.

Another factor contributing to the deficit reduction and improved fiscal management has been the provision of more and better professional assessments of the budgetary implications of various alternative policies and outcomes such as those provided by the Office of Management and Budget (OMB) in the executive branch and the Congressional Budget

Office (CBO) in the legislative branch. These agencies have greatly improved the informational base, making it more difficult for individual legislators to mislead other legislators about the benefits and costs of their "pet" projects and therefore more difficult for the proponents to get the votes of these other legislators.

Perhaps even more important has been the imposition of institutional constraints on the budgetary process and its outcomes. These constraints have been sufficiently flexible so as to be politically and administratively feasible, and at the same time, have been sufficiently strong to substantially reduce the fiscal deficits. The most important of these are the spending caps on discretionary expenditures and PAY-GO rules on law-mandated programs that were adopted in 1990 and 1993. These measures proved to be much more self-enforcing and sustainable than the earlier and better-known Gramm-Hollings-Rudman Act. The Gramm-Hollings-Rudman Act had prescribed predetermined deficit ceilings that had to be met regardless of economic conditions. When these ceilings could not be met, it gave rise to the use of various bookkeeping gimmicks, such as the relegation of some expenditure to the "off-budget." However, doing so undermined the integrity of the whole process. In contrast, the Budget Enforcement Act of 1990 allowed the budget deficit to vary with overall economic conditions. By PAY-GO rules is meant that increases in legally mandated programs cannot be increased without indicating, and obtaining explicit legislative approval for, where and how the extra funding requirements would come from.

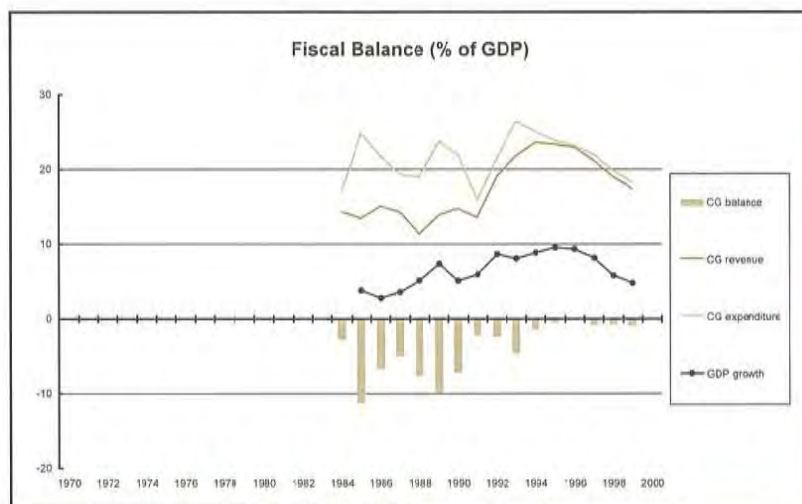
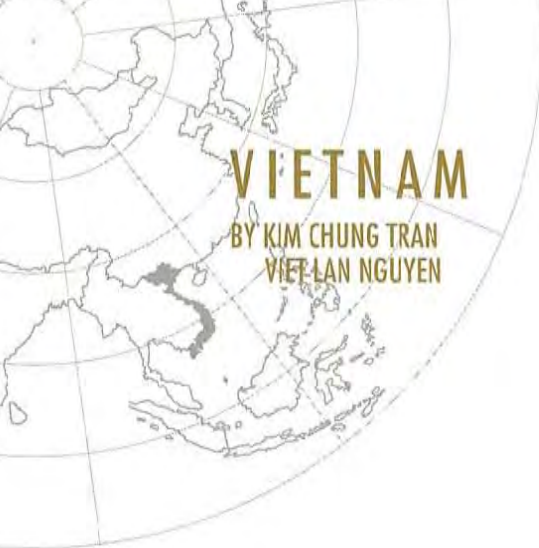
At present, however, with the prospect of looming surpluses over the next decade, these institutional and other constraints on fiscal deficits will be severely tested. Indeed, large-scale tax reductions seem likely. If appropriate fiscal constraints cannot be sustained, there is some danger that the U.S. could again be running severe fiscal deficits by about 2010. The long time that it took for the U.S. to rectify the large fiscal deficits of the early 1980s underscores the importance of not getting into that situation again.

Still another source of successful deficit reduction in the U.S. has been the relatively higher growth

rate in the 1990s and reduced unemployment rates in the late 1990s. Yet, even after controlling for business cycle changes, the federal budgetary balance has improved substantially between the late 1980s and 2000.

A consequence of the institutional changes that have taken place over time, however, has been that discretionary fiscal policy is less useful as a stabilization tool. There is a certain amount of automatic, built-in stabilization embedded in the budget process, but discretionary stabilization policy is increasingly limited to monetary policy. While this can allow fiscal policy to pursue other goals—such as growth, efficiency, environmental cleanliness and distributional equity—the only way that the stabilizing effect of the fiscal system can be retained is by strengthening the automatic stabilizers, such as making the time-phasing of the replacement of public capital and welfare transfers more strongly countercyclical.

Notably absent from the debate over what to do about the looming fiscal surplus has been an analysis of the effects of a sharp reduction in government debt on PECC and other countries that hold large amounts of U.S. government debt, including the implications of this for the stability of their financial systems. Because of the ever-increasing degree of globalization, and the fact that the foreign share of U.S. Treasury debt has been gradually rising to almost 23 percent in 1999, U.S. policymakers should in the future pay more attention to the effects of its policies on the rest of the world.



Since 1986, Vietnam has adopted a gradual approach along with some “small shocks” to reform its economy toward a market-based one. In the period before 1986, fiscal policies reflected the central planning regime. In the subsequent period 1986–1989, adjustments for reform were initiated. In the 1990–1998 period, there was an acceleration toward a market economy, and since 1998, fiscal policies have concentrated on deepening the reform. As part of the fiscal reforms, institutions involved in fiscal management were reorganized. Before 1990, the main institutions included the State Planning Committee, the Ministry of Finance, and the State Bank of Vietnam. After 1990, the Ministry of Planning and Investment, formerly the SPC, became the body with the duty of developing the fiscal plan of revenue and expenditure, and the Ministry of Finance (along with other organizations) has the responsibility of fiscal management.

Three points need to be emphasized for the 1990–1998 period. First, the tax code system that was approved by the National Assembly from 1990–1996 is almost complete. During 1990–1998, many laws and ordinances relating to fiscal matters were approved (currently, nine types of taxes have been approved). Second, some of the most important laws were approved in this period. The Law on Budget, one of the most important laws in Vietnam’s transition toward a market-based economy, was approved. This law, which focuses on revenue and expenditure as well as financing of the budget balance, identified four levels of the government

budget: the national level, the provincial level, the district level, and the commune level. The Budget Law also clarified the rule and decentralization system between the four levels of the budget system, and clearly pointed out the resources that each budget level can obtain and expend. Third, the process of tax code system approval is a gradual approach. Thus far, many things still need to be improved to complete the reform of the tax system.

The overall view of the fiscal situation in Vietnam has shown improvement. The budget deficit in 1976–1980 was 11.3 percent of GDP on average, and in 1981–1985, it was 13.4 percent. By 1986–1990, the deficit had declined to 6.5 percent, and during 1990–1999, it was kept lower than 5 percent of GDP. In addition, domestic revenue followed the same trend as total revenue which increased in 1993 and declined thereafter until 1999. The balance between domestic revenue and current expenditure in this period is positive at about 5 percent of GDP. All indicators showed improvement up until 1996, but decreased from 1997 onward and have recovered since 2000.

Government expenditure can be viewed in two phases: 1990–1996 and 1997 onward. In the first phase, fiscal policy appears to have followed the Keynesian model whereby increases in government expenditure led to increases in GDP, the CPI, and then the interest rate. In the second phase, the effect of fiscal policy has not followed the Keynesian model. Although government expenditure

increased 17.5 and 15.0 percent, respectively, in 1999 and 2000, the interest rate and household consumption decreased, and, national income increased in 2000.

One explanation for this reflects the fact that the transition toward a market-based economy is a gradual process. In the initial years of Vietnam's transition, the market mechanism fulfilled its role in policing the economy. However, the market mechanism that began operating in the goods and services market is only now starting to function in the financial market (the stock market began operations in July 2000). The market mechanism is not yet fully in place in the property and labor markets as well. Thus, these markets remain isolated, and there is no channel to allow movement of resources between these markets. As a result, with the increase in government expenditure, national income increased and the increase in household income followed. However, household consumption did not increase as some of the household savings was put into the property market and their savings was pulled away from gold and foreign currencies.

In terms of addressing poverty, Vietnam made significant achievements in poverty alleviation in the 1986–1998 period. The ratio of social expenditure as a share of GDP increased from 4.35 percent in 1991 to 7.95 percent in 1995, and then declined to 7.0 percent in 1998. The share of social expenditure to ordinary expenditure, however, continuously increased from 38 to 46 and 50 percent, respectively. The situation was similar for expenditure on education and social protection, but differed slightly for expenditure on healthcare. Meanwhile, during the 1992–1998 period, the government provided more than VND10 billion for poverty alleviation through national programs and the implementation of social policies. As a result, the overall poverty rate fell from 58 percent in 1993 to 37 percent in 1998. In the same two years, the food poverty rate was reduced from 25 percent to 15 percent, or an average reduction of 2 percent per year. The living standards of the poor people have improved compared to what they were five years ago. Inequality has been reduced, as shown by the decline in the square poverty gap index from 7.87 percent to 3.55 percent.

In the coming years, there are some prospects for

fiscal reform. First, objectives have been clearly defined such that expenditure should focus on the construction of rural infrastructure such as schools, healthcare stations, electric power supply, safe water, market and rural/communal roads. Second, economic prospects are good and fiscal management reform will need to continue to be supportive of growth and development. The taxation system is being reformed to be more oriented towards a market-based economy, and public expenditure is being reviewed with support from international financial institutions. Third, the government is paying more attention to the poverty issue along with international organizations, bilateral donors as well as NGOs that have been providing considerable assistance. However, there are also some main challenges. The poverty rate, though considerably reduced, is still high. Social expenditure has increased but is not sustainable. Fiscal management reform has had a positive impact on poverty alleviation but there have been problems with regards to the effectiveness of the programs, and this needs further review.

Therefore, it could be suggested that planning and discipline should be strengthened in fiscal management. Meanwhile, the ability to forecast the fiscal budget should be improved. Transparency should be increased in fiscal operation and management. Government revenue policy should be simple, and easy to understand and implement, but with adequate terms in order to manage all stages of collection work. Additionally, expenditure should be based on a development orientation, and priority given to paying off outstanding domestic and foreign debt. Attention will be paid to possible negotiation to reschedule the debt payment or borrow to pay the former debt. Finally, the government expenditure mechanism should be restructured to follow the principles of thrift, effectiveness and transparency.